

# You Wish To Earn A Return Of 13% On Each Of Two Stocks, X And Y. Stock X Is Expected To Pay A Dividend

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## Introduction

Investors often aim for specific returns based on their financial goals, risk appetite, and market conditions. In this scenario, an investor seeks a 13% return from two stocks, X and Y. Stock X is expected to pay dividends, which can form a significant part of the total return, while Stock Y's return is primarily expected from capital appreciation or other income streams. Understanding how to evaluate these stocks to meet the desired return involves analyzing dividend yields, expected growth, and risk factors associated with each investment.

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## Understanding the Target Return of 13%

### What Does a 13% Return Mean?

A 13% return on an investment signifies earning 13 units of profit for every 100 units invested over a specified period, typically annually. This return encompasses:

- Dividend income (for stocks paying dividends)
- Capital gains or appreciation in stock price
- Any other income streams (like special dividends or rights issues)

Achieving this return consistently requires a comprehensive analysis of both stocks' expected performance.

### Components of Total Return

For stocks, total return comprises:

- Dividend Yield: The annual dividends divided by the stock price.
- Capital Gains Yield: The percentage increase in stock price over the period.
- Total Return = Dividend Yield + Capital Gains Yield

In the case of Stock X, which pays dividends, both components are relevant. For Stock Y, which may not pay dividends, capital appreciation is likely the primary source.

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## Evaluating Stock X: Dividend Expectations and Return Components

## Dividend Discount Model (DDM)

Since Stock X is expected to pay dividends, the Dividend Discount Model provides a framework to estimate its fair value and required return.

Gordon Growth Model (a form of DDM):

$$P_0 = \frac{D_1}{r - g}$$

where:

- $P_0$  = current stock price
- $D_1$  = dividend expected next year
- $r$  = required rate of return (here, 13%)
- $g$  = expected dividend growth rate

### Calculating the Required Dividend

Suppose the current stock price  $P_0$  is known or set, and the investor wants a 13% return. With an expected dividend growth rate  $g$ , the dividend  $D_1$  can be calculated as:

$$D_1 = P_0 (r - g)$$

Alternatively, if the dividend  $D_0$  (current dividend) is known, the expected dividend next year can be projected as:

$$D_1 = D_0 (1 + g)$$

### Implications for Stock X

- To achieve a 13% return, the dividend yield plus growth must meet this target.
- For example, if the dividend yield is 4%, then the expected growth rate  $g$  should be approximately 9% to reach the total of 13%.

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## Evaluating Stock Y: Capital Appreciation and Risk

### Capital Gains Approach

If Stock Y does not pay dividends, the return depends solely on the increase in stock price:

$$\text{Expected Price in one year} = P_0 (1 + g)$$

where  $g$  is the expected growth rate in stock price.

To achieve a 13% return:

$$g \approx 13\%$$

### Risk Considerations

- Growth stocks often have higher volatility, which impacts the likelihood of achieving the expected appreciation.
- The investor must evaluate:
  - Market conditions affecting Stock Y's industry
  - Company fundamentals and growth prospects
  - Overall economic environment

### Estimating Future Price

Investors may use models like discounted cash flow (DCF) analysis or relative valuation to estimate  $P_1$ , the expected future price, aligned with the 13% target.

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### Comparing Stocks X and Y

#### Risk-Return Profiles

| Aspect            | Stock X                                 | Stock Y                                 |
|-------------------|-----------------------------------------|-----------------------------------------|
| Income Source     | Dividends                               | Capital appreciation                    |
| Risk Level        | Generally lower if dividends are stable | Usually higher due to market volatility |
| Return Components | Dividend yield + growth                 | Price appreciation                      |

#### Investment Strategies

- For Stock X: Focus on dividend stability and growth prospects to ensure the total return reaches 13%.
- For Stock Y: Emphasize growth potential and market conditions that support price appreciation.

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### Practical Approach to Achieve 13% Return

#### Step 1: Gather Data

- Current stock prices
- Dividend payments (for Stock X)
- Historical growth rates
- Analyst forecasts

#### Step 2: Calculate Required Metrics

- For Stock X:
  - Determine the necessary dividend yield and growth rate.
  - Ensure dividend payments are sustainable.
- For Stock Y:

- Estimate the required capital appreciation rate.

### Step 3: Analyze the Stocks

- Conduct fundamental analysis to assess growth prospects.
- Evaluate risk factors affecting future returns.
- Consider diversification to mitigate risks.

### Step 4: Make Investment Decisions

- Decide on the allocation based on risk tolerance.
- For a balanced approach, invest proportionally in both stocks to meet the overall return target.

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## Risk Management and Considerations

### Market Risks

- Economic downturns
- Sector-specific issues
- Changes in interest rates affecting valuations

### Company-Specific Risks

- Management performance
- Competitive position
- Financial health

### Diversification

- Reduces unsystematic risk
- Ensures more stable returns aligned with the target

### Monitoring and Rebalancing

- Regularly review performance against expectations.
- Adjust holdings if market conditions change or if projections are not met.

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## Conclusion

Achieving a targeted return of 13% on two stocks, one paying dividends (Stock X) and the other primarily appreciating in value (Stock Y), requires a careful blend of valuation analysis, growth estimation, and risk management. For Stock X, understanding dividend sustainability and growth prospects is essential, while for Stock Y, growth forecasts and market conditions play a pivotal role. By systematically analyzing each stock's fundamentals and aligning expectations with market realities, investors can position themselves to meet their return goals while managing associated risks effectively.

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## Final Remarks

Investors should remember that no investment guarantees a fixed return, and market conditions can fluctuate unexpectedly. Setting realistic expectations, conducting thorough research, and maintaining a diversified portfolio are key strategies to achieving desired returns like the 13% target in this scenario.

## Frequently Asked Questions

### **What does it mean to earn a 13% return on stocks X and Y?**

Earning a 13% return means that the total profit or gain from each stock, including dividends and capital appreciation, is expected to be 13% of the investment amount over a specified period.

### **How is the expected dividend from Stock X calculated if I aim for a 13% return?**

The expected dividend from Stock X can be estimated by dividing the desired return (13%) by the stock's current price, considering the dividend yield component that contributes to the total return.

### **What are the key factors to consider when investing in Stocks X and Y for a 13% return?**

Key factors include the stocks' historical performance, dividend payout history (for Stock X), growth prospects, market conditions, and the risk profile associated with each stock.

### **How can I assess whether Stock Y will provide a 13% return?**

You can assess Stock Y's potential by analyzing its expected capital gains, dividend payments, earnings growth, and comparing these with the current stock price to estimate if the total return meets 13%.

### **Is it realistic to expect a consistent 13% return from stocks X and Y?**

While some stocks may historically achieve such returns, market volatility and economic factors can impact consistency. It's important to diversify and consider risk before expecting fixed returns.

### **What role do dividends play in achieving a 13% return on Stock X?**

Dividends contribute directly to the total return, so a higher dividend payout can help reach the target 13%, especially if capital gains are modest or uncertain.

## **How can I balance risk and return when aiming for a 13% return on these stocks?**

Balancing risk involves analyzing each stock's volatility, dividend stability, earnings growth prospects, and diversifying investments to mitigate potential losses while aiming for the desired return.

## **What investment strategies can help achieve a 13% return on Stocks X and Y?**

Strategies include growth investing, dividend reinvestment, dollar-cost averaging, and conducting thorough fundamental analysis to select stocks with strong growth potential and reliable dividends.

## **Additional Resources**

Investment Strategy: Achieving a 13% Return with Stocks X and Y

In the world of investing, the pursuit of high returns often comes with the challenge of balancing risk and reward. For investors eyeing a consistent 13% return on their investments in two stocks—denoted here as Stock X and Stock Y—the path involves careful analysis of dividend policies, growth prospects, valuation metrics, and risk management strategies. This article provides an in-depth exploration of how to approach such a goal, with a particular focus on Stock X's dividend-paying potential and the broader investment considerations involved.

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