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Chapter 1 : Modern portfolio theory - Wikipedia

and the capital asset pricing model, (4) arbitrage pricing theory, (5) option pricing When we combine the theory of choice with the objects of choice, we the solutions manual will be employed almost as if it were a supplementary text.

Aim to maximize economic utilities Asset quantities are given and fixed. Are rational and risk-averse. Are broadly diversified across a range of investments. Are price takers, i. Can lend and borrow unlimited amounts under the risk free rate of interest. Trade without transaction or taxation costs. Deal with securities that are all highly divisible into small parcels All assets are perfectly divisible and liquid. Problems[edit] In their review, Fama and French argue that "the failure of the CAPM in empirical tests implies that most applications of the model are invalid". However, the history may not be sufficient to use for predicting the future and modern CAPM approaches have used betas that rely on future risk estimates. A critique of the traditional CAPM is that the risk measured used remains constant non-varying beta. Recent research has empirically tested time-varying betas to improve the forecast accuracy of the CAPM. Indeed, risk in financial investments is not variance in itself, rather it is the probability of losing: Barclays Wealth have published some research on asset allocation with non-normal returns which shows that investors with very low risk tolerances should hold more cash than CAPM suggests. This possibility is studied in the field of behavioral finance , which uses psychological assumptions to provide alternatives to the CAPM such as the overconfidence-based asset pricing model of Kent Daniel, David Hirshleifer , and Avanidhar Subrahmanyam Empirical studies show that low beta stocks may offer higher returns than the model would predict. Either that fact is itself rational which saves the efficient-market hypothesis but makes CAPM wrong , or it is irrational which saves CAPM, but makes the EMH wrong â€" indeed, this possibility makes volatility arbitrage a strategy for reliably beating the market. It does not allow for active and potential shareholders who will accept lower returns for higher risk. Casino gamblers pay to take on more risk, and it is possible that some stock traders will pay for risk as well. This assumes no preference between markets and assets for individual active and potential shareholders, and that active and potential shareholders choose assets solely as a function of their risk-return profile. It also assumes that all assets are infinitely divisible as to the amount which may be held or transacted. In practice, such a market portfolio is unobservable and people usually substitute a stock index as a proxy for the true market portfolio. Unfortunately, it has been shown that this substitution is not innocuous and can lead to false inferences as to the validity of the CAPM, and it has been said that due to the inobservability of the true market portfolio, the CAPM might not be empirically testable. This is in sharp contradiction with portfolios that are held by individual shareholders: The circularity refers to the price of tota risk being a function of the price of covariance risk only and vice versa.

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These notes are based on Asset Pricing and Portfolio Choice Theory by Kerry Back. We thank Professor We thank Professor Back for his kindly and enormous support.