Finance 34600 - Investment Theory

Outline for Lecture 2
Portfolio Theory

The purpose of Lecture 2 is to develop the concepts of portfolio theory and efficient diversification. We will begin by describing investor risk preferences and the relationship between risk and return. To do this, we will develop the economic concept of utility and also the statistical analysis of Probability of Loss.

We then shift our attention to the capital allocation decision and examine the construction of portfolios consisting of a risky asset and a risk-free asset. The risk/return characteristics of portfolios will be quantified in terms of the reward-to-variability ratio and the Capital Allocation Line (CAL).

We then move on to examine portfolios of risky assets and the determination of the optimal risky portfolio. This discussion will focus on the concepts of diversification, the efficient frontier, and the *two-fund separation* property of portfolio choice.

Suggested Problems:

Ch. 5: 6, 7, 9, 10, 15, 18, 19-22, plus Excel Example 1.

Ch. 6: 6-10, 12, 14-16.