Introduction

In the next three chapters, we will examine different aspects of capital market theory, including:
- Bringing risk and return into the picture of investment management – Markowitz optimization
- Modeling risk and return – CAPM, APT, and variations
- Estimating risk and return – the Single-Index Model (SIM) and risk and expected return factor models
- These provide the framework for both modern finance, which we have briefly discussed already, as well as for quantitative investment management, which will be the subject of the next section of the course

Chapter 7 - An Introduction to Portfolio Management

Questions to be answered:
- What do we mean by risk aversion and what evidence indicates that investors are generally risk averse?
- What are the basic assumptions behind the Markowitz portfolio theory?
- What is meant by risk and what are some of the alternative measures of risk used in investments?

Chapter 7 - An Introduction to Portfolio Management

- How do you compute the expected rate of return for an individual risky asset or a portfolio of assets?
- How do you compute the standard deviation of rates of return for an individual risky asset?
- What is meant by the covariance between rates of return and how do you compute covariance?

Chapter 7 - An Introduction to Portfolio Management

- What is the relationship between covariance and correlation?
- What is the formula for the standard deviation for a portfolio of risky assets and how does it differ from the standard deviation of an individual risky asset?
- Given the formula for the standard deviation of a portfolio, how and why do you diversify a portfolio?

Chapter 7 - An Introduction to Portfolio Management

- What happens to the standard deviation of a portfolio when you change the correlation between the assets in the portfolio?
- What is the risk-return efficient frontier?
- Is it reasonable for alternative investors to select different portfolios from the portfolios on the efficient frontier?
- What determines which portfolio on the efficient frontier is selected by an individual investor?
Background Ideas

- As an investor you want to maximize the returns for a given level of risk.
- The relationship between the returns for the different assets in the portfolio is important.
- A good portfolio is not simply a collection of individually good investments.

Risk Aversion

Given a choice between two assets with equal rates of return, most investors will select the asset with the lower level of risk. Risk aversion is a consequence of decreasing marginal utility of consumption.

Evidence That Investors are Risk-Averse

- Many investors purchase insurance for: Life, Automobile, Health, and Disability Income. The purchaser trades known costs for unknown risk of loss.
- Yields on bonds increase with risk classifications, from AAA to AA to A …
- Lottery tickets seemingly contradict risk aversion, but provide potential for purchasers to move into a new class of consumption.

Definition of Risk

But, how do you actually define risk?
1. Uncertainty of future outcomes
2. Probability of an adverse outcome

Markowitz Portfolio Theory

- Old adage is:
  - “Don’t put all your eggs in one basket.”
  - But, how many baskets should you use?
  - And how what proportion of your eggs should you put in each basket?
- Harry Markowitz
  - wrestled with these questions
  - figured out a way to answer both of them
  - Earned a Nobel Prize in Economics (1990) for his efforts

Markowitz Portfolio Theory

- Quantifies risk
- Derives the expected rate of return for a portfolio of assets and an expected risk measure
- Shows that the variance of the rate of return is a meaningful measure of portfolio risk
- Derives the formula for computing the variance of a portfolio, showing how to effectively diversify a portfolio
- Provides both:
  - the foundation for Modern Finance
  - a key tool for Haugen’s New Finance
Assumptions of Markowitz Portfolio Theory

1. Investors consider each investment alternative as being presented by a probability distribution of expected returns over some holding period.

2. Investors minimize one-period expected utility, and their utility curves demonstrate diminishing marginal utility of wealth.
   - I.e., investors like higher returns, but they are risk-averse in seeking those returns
   - And, again, this is a one-period model (i.e., the portfolio will need to be rebalanced at some point in the future in order to remain optimal)

3. Investors estimate the risk of the portfolio on the basis of the variability of expected returns.
   - I.e., out of all the possible measures, variance is the key measure of risk

4. Investors base decisions solely on expected return and risk, so their utility curves are a function of only expected portfolio returns and the expected variance (or standard deviation) of portfolio returns.
   - Investors’ utility curves are functions of only expected return and the variance (or standard deviation) of returns.
   - Stocks’ returns are normally distributed or follow some other distribution that is fully described by mean and variance.

5. For a given risk level, investors prefer higher returns to lower returns. Similarly, for a given level of expected returns, investors prefer less risk to more risk.

Using these five assumptions, a single asset or portfolio of assets is considered to be efficient if no other asset or portfolio of assets offers higher expected return with the same (or lower) risk, or lower risk with the same (or higher) expected return.
Expected Rates of Return

- For an individual asset:
  - sum of the potential returns multiplied with the corresponding probability of the returns
- For a portfolio of assets:
  - weighted average of the expected rates of return for the individual investments in the portfolio

Computation of Expected Return for an Individual Risky Investment

\[
E(R) = \sum P_i R_i
\]

where:
- \( P_i \) = the probability of state occurring
- \( R_i \) = the return in stock on return

Expected Return (Percent) Probability Possible Rate of Return (Percent) Expected Return (Percent)
\[
\begin{array}{cccc}
0.25 & 0.08 & 0.0200 \\
0.25 & 0.10 & 0.0250 \\
0.25 & 0.12 & 0.0300 \\
0.25 & 0.14 & 0.0350 \\
\end{array}
\]

\[E(R) = 0.1100\]

Computation of the Expected Return for a Portfolio of Risky Assets

\[
E(R_{\text{por}}) = \sum W_i E(R_i)
\]

where:
- \( W_i \) = the percent of the portfolio in asset i
- \( E(R_i) \) = the expected rate of return for asset i

Expected Portfolio Return (\(W_i X R_i\)) (Percent of Portfolio) Expected Security Return (\(R_i\)) Weight (\(W_i\))
\[
\begin{array}{cccc}
0.20 & 0.10 & 0.0200 \\
0.30 & 0.11 & 0.0330 \\
0.30 & 0.12 & 0.0360 \\
0.20 & 0.13 & 0.0260 \\
\end{array}
\]

\[E(R_{\text{por}}) = 0.1150\]

Variance (Standard Deviation) of Returns for an Individual Investment

Variance is a measure of the variation of possible rates of return \(R_i\), away from the expected rate of return \(E(R_i)\).
Standard deviation is the square root of the variance.

\[
\text{Variance} = \sigma^2 = \sum (R_i - E(R_i))^2 P_i
\]

Variance \((\sigma^2) = .0050\)
Standard Deviation \((\sigma) = .02236\)

Variance and Standard Deviation of Returns for an Individual Investment Formulas:
Standard Deviation of Returns for a Portfolio

Formula:

Two-Stock:

More than two stocks:

Portfolio Standard Deviation Calculation

- Any asset of a portfolio may be described by two characteristics:
  - The expected rate of return
  - The expected standard deviations of returns
- A third characteristic, the covariance between a pair of stocks, also drives the portfolio standard deviation
  - Unlike portfolio expected return, portfolio standard deviation is not simply a weighted average of the standard deviations for the individual stocks
  - For a well-diversified portfolio, the main source of portfolio risk is covariance risk; the lower the covariance risk, the lower the total portfolio risk

Covariance of Returns

- Covariance is a measure of:
  - the degree of “co-movement” between two stocks’ returns, or
  - the extent to which the two variables “move together” relative to their individual mean values over time

Covariance of Returns

For two assets, i and j, the covariance of rates of return is defined as:

\[
\sigma_{ij} = \sum_{n=1}^{N} \left( R_{ni} - E(R_i) \right) \left( R_{nj} - E(R_j) \right) P_{i,j}
\]

or

\[
\sigma_{ij} = \sum_{n=1}^{N} \left( R_{ni} - E(R_i) \right) \left( R_{nj} - E(R_j) \right) P_{i,j}
\]

Covariance and Correlation

- The correlation coefficient is obtained by standardizing (dividing) the covariance by the product of the individual standard deviations

Covariance and Correlation

Correlation coefficient varies from -1 to +1

\[
\rho_{ij} = \frac{\text{Cov}_{ij}}{\sigma_i \sigma_j}
\]

where:

- \( \rho_{ij} \) = the correlation coefficient of returns
- \( \sigma_i \) = the standard deviation of \( R_i \)
- \( \sigma_j \) = the standard deviation of \( R_j \)
Correlation Coefficient

- It can vary only in the range +1 to -1. A value of +1 would indicate perfect positive correlation. This means that returns for the two assets move together in a completely linear manner. A value of -1 would indicate perfect correlation. This means that the returns for two assets have the same percentage movement, but in opposite directions.

Parameters vs. Estimates

- Unfortunately, no one knows the true values for the expected return and variance and covariance of returns.
- These must be estimated from the available data.
- The most basic way to estimate these is the naïve or unconditional estimate:
  - uses the sample mean, sample variance, and sample covariance from a time series sample of stock returns.
  - Typical time series used is last 60 months (5 years') worth of monthly returns.
  - More sophisticated methods for estimating these will be discussed in subsequent chapters.

Computation of Monthly Rates of Return

Exhibit 7.4

<table>
<thead>
<tr>
<th>Date</th>
<th>Closing Price</th>
<th>Dividend</th>
<th>Return (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec.00</td>
<td>60.938</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan.01</td>
<td>58.000</td>
<td>-4.82%</td>
<td></td>
</tr>
<tr>
<td>Feb.01</td>
<td>53.650</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mar.01</td>
<td>52.300</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apr.01</td>
<td>51.800</td>
<td>2.51%</td>
<td></td>
</tr>
<tr>
<td>May.01</td>
<td>52.100</td>
<td>0.58%</td>
<td></td>
</tr>
<tr>
<td>Jun.01</td>
<td>53.600</td>
<td>-4.68%</td>
<td></td>
</tr>
<tr>
<td>Jul.01</td>
<td>52.500</td>
<td>0.27%</td>
<td></td>
</tr>
<tr>
<td>Aug.01</td>
<td>52.800</td>
<td>1.28%</td>
<td></td>
</tr>
<tr>
<td>Sep.01</td>
<td>53.500</td>
<td>2.95%</td>
<td></td>
</tr>
<tr>
<td>Oct.01</td>
<td>51.500</td>
<td>-0.23%</td>
<td></td>
</tr>
<tr>
<td>Nov.01</td>
<td>49.100</td>
<td>-7.12%</td>
<td></td>
</tr>
<tr>
<td>Dec.01</td>
<td>47.100</td>
<td>5.56%</td>
<td></td>
</tr>
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</table>

E(R_Coca-Cola) = -1.81% E(R_Home Depot) = 1.47%


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</table>

E(R_Coca-Cola) = -1.81% E(R_Home Depot) = 1.47%

Estimation of Standard Deviation of Returns for Coca-Cola and Home Depot: 2001

<table>
<thead>
<tr>
<th>Date</th>
<th>R_i - E(R_i)</th>
<th>(R_i - E(R_i))^2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan.01</td>
<td>-1.61%</td>
<td>0.000365</td>
</tr>
<tr>
<td>Feb.01</td>
<td>1.54%</td>
<td>0.001594</td>
</tr>
<tr>
<td>Mar.01</td>
<td>1.93%</td>
<td>0.000508</td>
</tr>
<tr>
<td>Apr.01</td>
<td>1.54%</td>
<td>0.000508</td>
</tr>
<tr>
<td>May.01</td>
<td>1.93%</td>
<td>0.000508</td>
</tr>
<tr>
<td>Jun.01</td>
<td>-1.61%</td>
<td>0.000365</td>
</tr>
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<td>1.54%</td>
<td>0.001594</td>
</tr>
<tr>
<td>Sep.01</td>
<td>1.54%</td>
<td>0.001594</td>
</tr>
<tr>
<td>Oct.01</td>
<td>1.54%</td>
<td>0.001594</td>
</tr>
<tr>
<td>Nov.01</td>
<td>1.54%</td>
<td>0.001594</td>
</tr>
<tr>
<td>Dec.01</td>
<td>1.54%</td>
<td>0.001594</td>
</tr>
</tbody>
</table>

Var(Coca-Cola) = 0.000403 / 12 = 0.000335
Var(Home Depot) = 0.000403 / 12 = 0.000335

Coca-Cola: 0.000335 1/2 = 0.0580
Home Depot: 0.000335 1/2 = 0.1017

Times Series Returns for Coca-Cola and Home Depot: 2001

Coca-Cola

Home Depot

[Graph showing times series returns]
**Scatter Plot of Monthly Returns for Coca-Cola and Home Depot: 2001**

**Estimation of Covariance of Returns for Coca-Cola and Home Depot: 2001**

<table>
<thead>
<tr>
<th>Date</th>
<th>Return (%)</th>
<th>Rj (%)</th>
<th>Ri - E(Ri)</th>
<th>Rj - E(Rj)</th>
<th>[Ri - E(Ri)] X [Rj - E(Rj)]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan.01</td>
<td>-4.82%</td>
<td>5.50%</td>
<td>-3.01%</td>
<td>4.03%</td>
<td>-0.001213</td>
</tr>
<tr>
<td>Feb.01</td>
<td>-8.57%</td>
<td>-11.83%</td>
<td>-6.76%</td>
<td>-13.30%</td>
<td>0.008984</td>
</tr>
<tr>
<td>Mar.01</td>
<td>-14.50%</td>
<td>1.51%</td>
<td>-12.69%</td>
<td>0.04%</td>
<td>-0.000050</td>
</tr>
<tr>
<td>Apr.01</td>
<td>2.28%</td>
<td>9.28%</td>
<td>4.09%</td>
<td>7.81%</td>
<td>0.003199</td>
</tr>
<tr>
<td>May.01</td>
<td>2.62%</td>
<td>4.65%</td>
<td>4.43%</td>
<td>3.18%</td>
<td>0.001411</td>
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<tr>
<td>Jun.01</td>
<td>-4.68%</td>
<td>-4.08%</td>
<td>-2.87%</td>
<td>-5.54%</td>
<td>0.001592</td>
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<tr>
<td>Jul.01</td>
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<td>6.63%</td>
<td>0.92%</td>
<td>5.16%</td>
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<tr>
<td>Aug.01</td>
<td>9.13%</td>
<td>-8.70%</td>
<td>10.94%</td>
<td>-10.16%</td>
<td>-0.011115</td>
</tr>
<tr>
<td>Sep.01</td>
<td>-3.37%</td>
<td>-16.50%</td>
<td>-1.56%</td>
<td>-17.96%</td>
<td>0.002797</td>
</tr>
<tr>
<td>Oct.01</td>
<td>2.20%</td>
<td>-0.36%</td>
<td>4.01%</td>
<td>-1.83%</td>
<td>-0.000735</td>
</tr>
<tr>
<td>Nov.01</td>
<td>-1.55%</td>
<td>22.16%</td>
<td>0.27%</td>
<td>20.69%</td>
<td>0.000552</td>
</tr>
<tr>
<td>Dec.01</td>
<td>0.40%</td>
<td>9.35%</td>
<td>2.22%</td>
<td>7.88%</td>
<td>0.001747</td>
</tr>
</tbody>
</table>

\[
E(R_{Coca-Cola}) = -1.81\% \quad E(R_{HomeDepot}) = 1.47\%
\]

\[
\text{Cov}_{ij} = 0.007645 \quad / \quad 12 \quad = \quad 0.000637
\]

\[
\text{Corr}(ij) = \frac{\text{Cov}_{ij}}{\sigma_i \sigma_j} = 0.1079
\]

**Combining Stocks with Different Returns and Risk**

- Assets may differ in expected rates of return and individual standard deviations
- Negative correlation reduces portfolio risk
- Combining two assets with -1.0 correlation reduces the portfolio standard deviation to zero only when individual standard deviations are equal

**Case Correlation Coefficient Covariance**

<table>
<thead>
<tr>
<th>Case</th>
<th>Correlation Coefficient</th>
<th>Covariance</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>+1.00</td>
<td>.0070</td>
</tr>
<tr>
<td>b</td>
<td>+0.50</td>
<td>.0035</td>
</tr>
<tr>
<td>c</td>
<td>0.00</td>
<td>.0000</td>
</tr>
<tr>
<td>d</td>
<td>-0.50</td>
<td>-.0035</td>
</tr>
<tr>
<td>e</td>
<td>-1.00</td>
<td>-.0070</td>
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</tbody>
</table>

**Constant Correlation with Changing Weights**

<table>
<thead>
<tr>
<th>Asset</th>
<th>E(Ri)</th>
<th>W1</th>
<th>W2</th>
<th>E(Rf)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.10</td>
<td>.50</td>
<td>.50</td>
<td>.0049</td>
</tr>
<tr>
<td>2</td>
<td>.20</td>
<td>.50</td>
<td>.50</td>
<td>.0070</td>
</tr>
</tbody>
</table>

**Case | W1 | W2 | E(Rf) | E(port) |
<table>
<thead>
<tr>
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<th></th>
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<tr>
<td>f</td>
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<td>1.00</td>
<td>.20</td>
<td>.0000</td>
</tr>
<tr>
<td>g</td>
<td>.20</td>
<td>.80</td>
<td>.18</td>
<td>.0018</td>
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<td>h</td>
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<td>.0062</td>
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<tr>
<td>i</td>
<td>.50</td>
<td>.50</td>
<td>.15</td>
<td>.0015</td>
</tr>
<tr>
<td>j</td>
<td>.60</td>
<td>.40</td>
<td>.14</td>
<td>.0014</td>
</tr>
<tr>
<td>k</td>
<td>.80</td>
<td>.20</td>
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<tr>
<td>l</td>
<td>1.00</td>
<td>.00</td>
<td>.10</td>
<td>.0700</td>
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</table>

**Constant Correlation with Changing Weights**

**Combining Stocks with Different Returns and Risk**

<table>
<thead>
<tr>
<th>Asset</th>
<th>E(Ri)</th>
<th>W1</th>
<th>W2</th>
<th>σi²</th>
<th>σf</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.10</td>
<td>.50</td>
<td>.50</td>
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<tr>
<td>2</td>
<td>.20</td>
<td>.50</td>
<td>.50</td>
<td>.0070</td>
<td>.10</td>
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</table>

**Case | Correlation Coefficient | Covariance |
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</tr>
</tbody>
</table>
With two perfectly correlated assets, it is only possible to create a two asset portfolio with risk-return along a line between either single asset.

With uncorrelated assets it is possible to create a two asset portfolio with lower risk than either single asset.

With correlated assets it is possible to create a two asset portfolio between the first two curves.

With negatively correlated assets it is possible to create a two asset portfolio with much lower risk than either single asset.

With perfectly negatively correlated assets it is possible to create a two asset portfolio with almost no risk.

The Efficient Frontier

- The efficient frontier represents that set of portfolios with the maximum rate of return for every given level of risk, or the minimum risk for every level of return.
- Frontier will be portfolios of investments rather than individual securities.
  - Exceptions being the asset with the highest return and the asset with the lowest risk.
The Efficient Frontier for Alternative Portfolios

Exhibit 7.15

The Efficient Frontier and Investor Utility

- An individual investor’s utility curve specifies the trade-offs he is willing to make between expected return and risk.
- The slope of the efficient frontier curve decreases steadily as you move upward.
- These two interactions will determine the particular portfolio selected by an individual investor.

The Efficient Frontier and Investor Utility

- The optimal portfolio has the highest utility for a given investor.
- It lies at the point of tangency between the efficient frontier and the utility curve with the highest possible utility.

Selecting an Optimal Risky Portfolio

Exhibit 7.16

Estimation Issues

- Results of portfolio allocation depend on accurate statistical inputs.
- Estimates of:
  - Expected returns (n estimates)
  - Standard deviation (n estimates)
  - Correlation coefficient (\(\frac{n(n-1)}{2}\) estimates)
    - Among entire set of assets
    - With 100 assets, 4,950 correlation estimates
    - With 500 assets, 124,750 correlation estimates
- Estimation risk refers to potential errors:
  - Typically only have between 60n and 200n observation data points from which to obtain estimates.

Estimation Issues

- With assumption that stock returns can be described by a single market model, the number of correlation inputs required reduces to the number of assets, plus one.
- Single index market model:
  \[ R_{it} = a_i + b_i R_m + \varepsilon_{it} \]
  - \( b_i \) is the slope coefficient that relates the returns for security i to the returns for the aggregate stock market.
  - \( R_{at} \) is the return for the aggregate stock market during time period t.
Estimation Issues
If all the securities are similarly related to the market and a $b_i$ derived for each one, it can be shown that the correlation coefficient between two securities $i$ and $j$ is given as:

$$ r_{ij} = b_i b_j \frac{\sigma_i^2}{\sigma_i \sigma_j} $$

where $\sigma_i^2 = \text{the variance of returns for the aggregate stock market}$

Implementation Issues
• If portfolios on the efficient frontier are optimal, why don’t all investors use Markowitz portfolio optimization?
• Three key problems complicate implementation:
  1. Too many inputs required
  2. Use of estimates can lead to “error maximization”
  3. Reliance on historical data to obtain estimates

Implementation Issues
1. Too many inputs required
   - Limit use to asset allocation or small-scale problems
   - Use factor models to obtain / develop correlation estimates
     • Allows for use with much larger scale problems
     • E.g., all 1700 stocks that Value Line follows
     • Simplest factor model is the “single-index market model”

Implementation Issues
2. Use of estimates can lead to “error maximization”
   - Introduce additional “hard” constraints in optimization process
     • E.g., Haugen, p. ??
     • Use stratified sampling
     • Precludes optimized portfolio from being too different from the benchmark portfolio
   - Use “portfolio resampling” to find average optimal portfolio given range of possible estimates

Implementation Issues
3. Reliance on historical data to obtain estimates
   - True parameters not only never known, but also not constant over time
   - Factor models and stratified sampling help here, too
     • Factor model relationships tend to be more stable than relationships between individual stocks
     • Stratified sampling constraints prevent portfolio from falling too far behind benchmark even when estimated relationships change

Minimum Variance Portfolio (MVP)
1. Two-stock case:

$$ \sigma_{\text{port}} = \sqrt{w_1 \sigma_1^2 + w_2 \sigma_2^2 + 2w_1 w_2 \text{Cov}_{12}} $$

2. Multiple stock case:

$$ \sigma^{\text{port}} = \sqrt{\sum_i w_i \sigma_i^2 + 2 \sum_i \sum_j w_i w_j \text{Cov}_{ij}} = \sqrt{\mathbf{w} \Sigma \mathbf{w}} $$
Future topics
Chapter 8
- Capital Market Theory
- Capital Asset Pricing Model
- Beta
- Expected Return and Risk
- Arbitrage Pricing Theory