

Lecture 4: Portfolio Diversification and Supporting Financial Institutions

Economics 252, Spring 2008

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Optimal Portfolio Diversification in General Case

- Drop assumption of equal weighting, independence and equal variance
- Put x_i dollars in i th asset, $I=1,...,n$, where the x_i sum to \$1.

- Portfolio expected value $r = \sum_{i=1}^n x_i E(\text{return}_i) = \sum_{i=1}^n x_i r_i$

- Portfolio variance (two assets) =

$$x_1^2 \text{var}(\text{return}_1) + (1 - x_1)^2 \text{var}(\text{return}_2) + 2x_1(1 - x_1) \text{cov}(\text{return}_1, \text{return}_2)$$

Efficient Portfolio Frontier with Two Assets

- Frontier expresses portfolio standard deviation in terms of portfolio expected return r rather than in terms of x_1 .

- $$x_1 = \frac{r - r_2}{r_1 - r_2}$$

$$\begin{aligned}\sigma^2 &= \left(\frac{r - r_2}{r_1 - r_2}\right)^2 \sigma_1^2 + \left(\frac{r_1 - r}{r_1 - r_2}\right)^2 \sigma_2^2 \\ &+ 2 \frac{(r - r_2)(r_1 - r)}{(r_1 - r_2)^2} \sigma_{12}\end{aligned}$$

Portfolio Variance, Three Assets

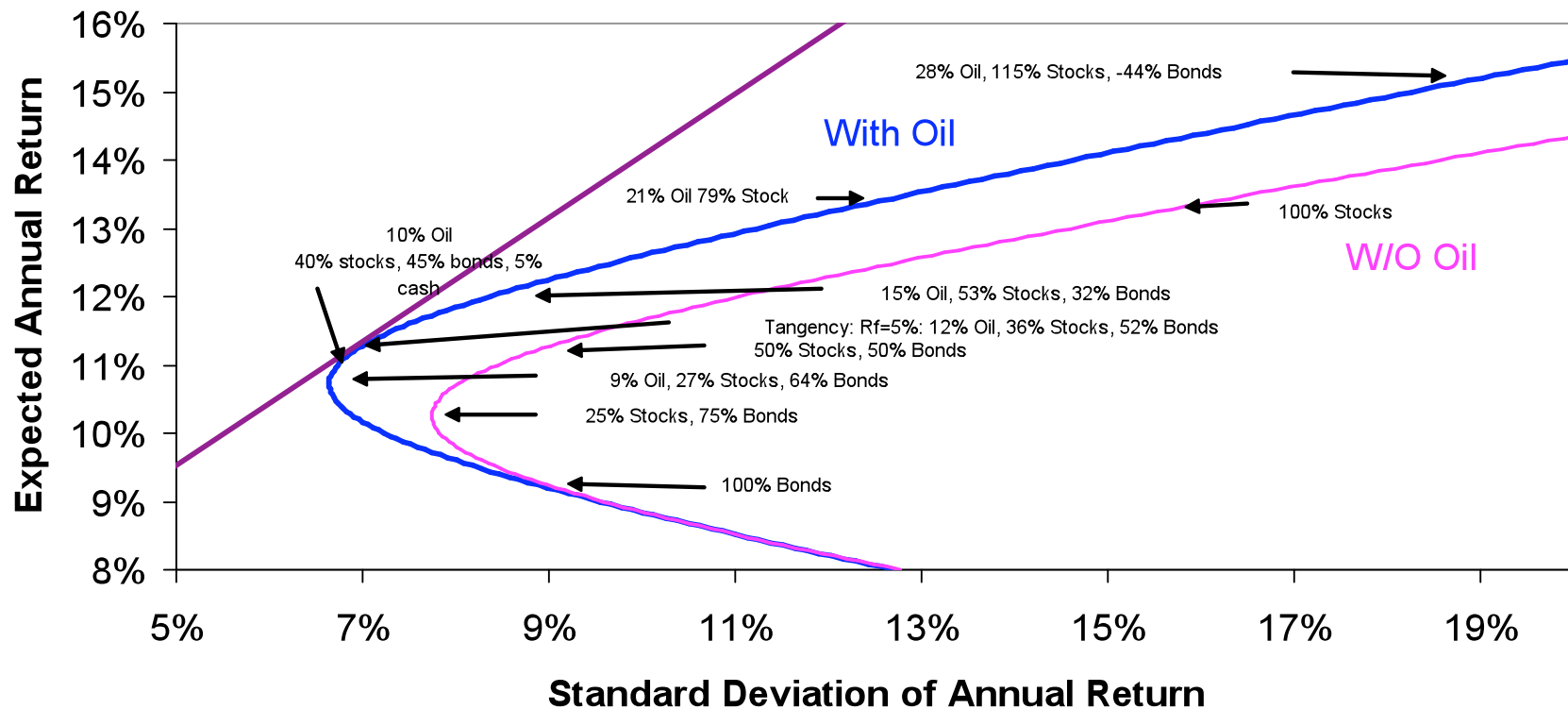
- Portfolio variance =

$$\begin{aligned} & x_1^2 \text{var}(\text{return}_1) + x_2^2 \text{var}(\text{return}_2) + x_3^2 \text{var}(\text{return}_3) \\ & + 2x_1x_2 \text{cov}(\text{return}_1, \text{return}_2) + 2x_1x_3 \text{cov}(\text{return}_1, \text{return}_3) \\ & + 2x_2x_3 \text{cov}(\text{return}_2, \text{return}_3) \end{aligned}$$

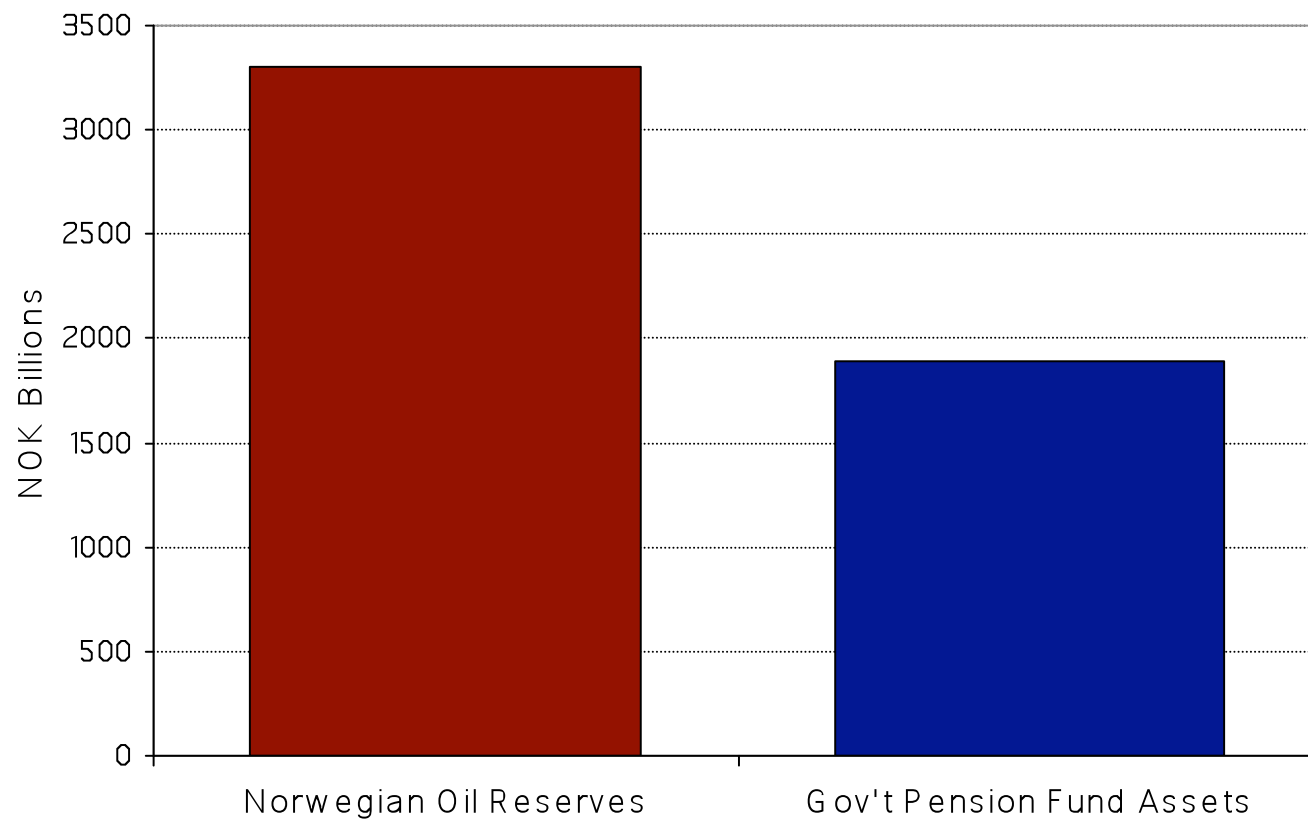
$$\text{(where } \sum_{i=1}^3 x_i = 1\text{)}$$

Efficient Portfolio Frontier

Efficient Portfolio Frontier With and Without Oil



Oil Reserves vs. Pension Fund Assets, 2006



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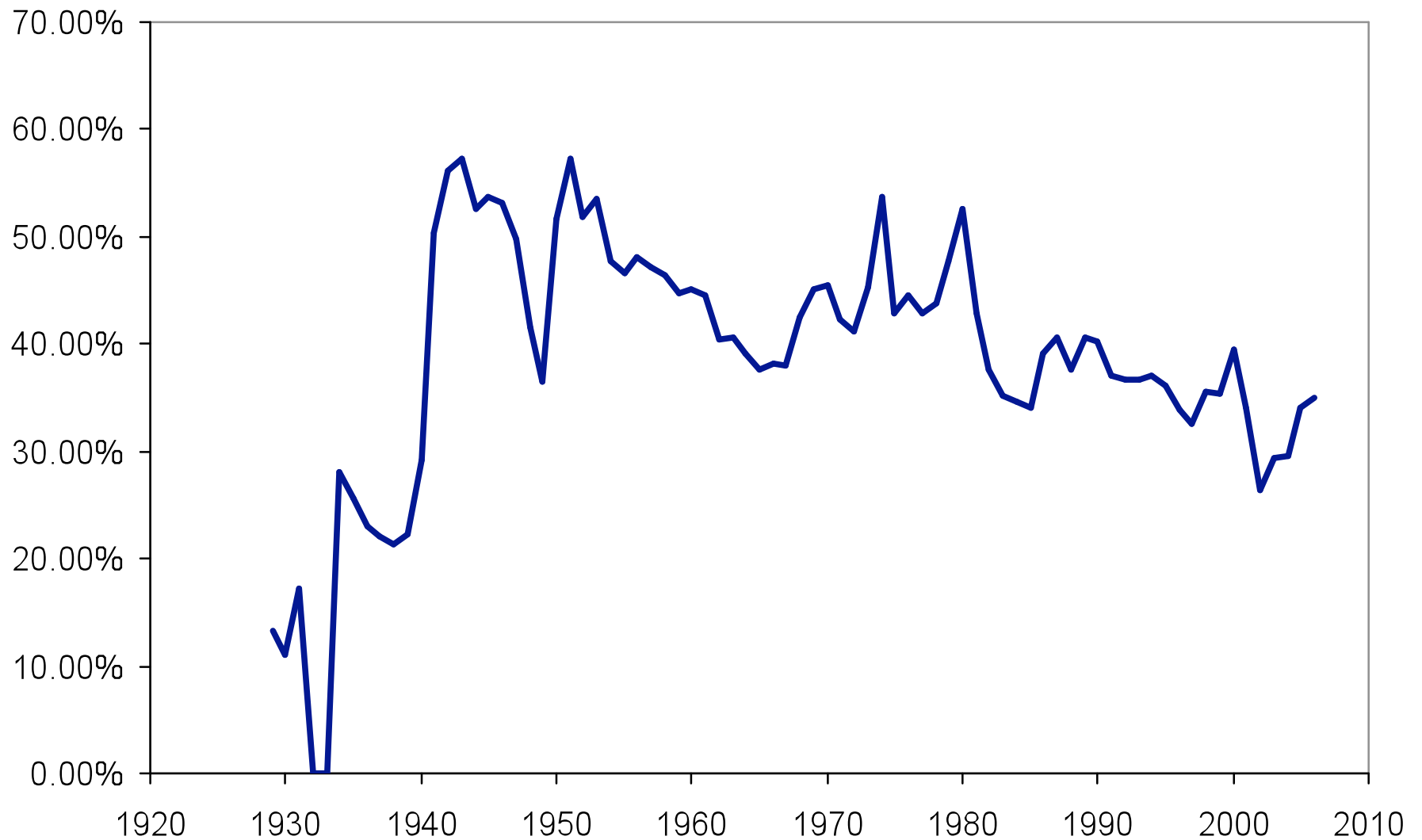
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Beta

- The CAPM implies that the expected return on the i th asset is determined from its beta.
- Beta (β_i) is the regression slope coefficient when the return on the i th asset is regressed on the return on the market.
- Fundamental equation of the CAPM:

$$r_i = r_f + \beta_i(r_m - r_f)$$

US Corporate Taxes / Corporate Income (Income was negative 1932, 1933)



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Survey of Individual Investors 1999

“Trying to time the market, to get out before it goes down and in before it goes up, is:

1. A smart thing to do; I can reasonably expect to be a success at it. 11%
2. Not a smart thing to do; I can't reasonably expect to be a success at it. 83%
3. No opinion 5%

Survey of Individual Investors 1999

“Trying to pick individual stocks, for example, if and when Ford Motor stock will go up, or IBM stock will go up, is:

1. A smart thing to do; I can reasonably expect to be a success at it. 40%
2. Not a smart thing to do; I can't reasonably expect to be a success at it. 51%
3. No opinion 8%

Survey of Individual Investors 1999

“Trying to pick mutual funds, trying to figure out which funds have experts who can themselves pick which stock will go up, is:

1. A smart thing to do; I can reasonably expect to be a success at it. 50%
2. Not a smart thing to do; I can't reasonably expect to be a success at it. 27%
3. No opinion 23%