

Chapter 7: CAPM

Some questions in this problem set are taken from the book *Investment Science* from Luenberger.

Question 1 (Capital Market Line):

1. (Capital market line) Assume that the expected rate of return on the market portfolio is 23% and the rate of return on T-bills (the risk-free rate) is 7%. The standard deviation of the market is 32%. Assume that the market portfolio is efficient.
- (a) What is the equation of the capital market line?
- (b) (i) If an expected return of 39% is desired, what is the standard deviation of this position? (ii) If you have \$1,000 to invest, how should you allocate it to achieve the above position?
- (c) If you invest \$300 in the risk-free asset and \$700 in the market portfolio, how much money should you expect to have at the end of the year?

(a) The capital market line is defined by:

$$\tilde{r}_i = E(r_i) = r_f + \frac{E(r_M) - r_f}{\sigma_M} \sigma_i = 0.07 + \frac{0.23 - 0.07}{0.32} \sigma_i$$

(b) (i)

$$0.39 = 0.07 + \frac{0.23 - 0.07}{0.32} \sigma_i \implies \sigma_i = \frac{0.32^2}{0.23 - 0.07} = 0.64$$

(ii)

$$\omega \times 0.07 + (1 - \omega) \times 0.23 = 0.39 \implies \omega = -1$$

\implies Borrow \$1000 at the risk-free rate and invest \$2000 into the market

(c)

$$300 \times (1.07) + 700 \times (1.23) = 1182$$

Question 2 (A small world):

2. (A small world) Consider a world in which there are only two risky assets, A and B , and a risk-free asset F . The two risky assets are in equal supply in the market; that is, $M = \frac{1}{2}(A + B)$. The following information is known: $r_f = 10$, $\sigma_A^2 = 04$, $\sigma_{A,B} = 01$, $\sigma_B^2 = 02$, and $\bar{r}_M = 18$.
- (a) Find a general expression (without substituting values) for σ_M^2 , β_A , and β_B .
- (b) According to the CAPM, what are the numerical values of \bar{r}_A and \bar{r}_B ?

(a) We use the calculation rules for the covariance of a sum of random variables (<https://en.wikipedia.org/wiki/Covariance>)

Luenberger Chapter 7 Problem

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Luenberger Chapter 7 Problem:

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