**Unit 7: Investment Theories**

[**https://quizlet.com/gb/881486960/unit-7-investment-theories-flash-cards/?i=24ef59&x=1qqt**](https://quizlet.com/gb/881486960/unit-7-investment-theories-flash-cards/?i=24ef59&x=1qqt)

**Modern Portfolio Theory: Holistic approach.**

Focus on risk of portfolio as a whole, not risk of individual components.

**Modern Portfolio Theory: Goal**

Making portfolio to maximise return for given level of risk.

**Modern Portfolio Theory: Every investor is ‘Risk Averse’**

Not all investors are cautious

Only take higher risk if = higher reward.

**Diversification: Quantity v Quality**

Quality equally important: negatively correlated assets.

**What does standard deviation measure?**

Spread of asset prices from their mean.

Indicates volatility.

**What does a low SD indicate?**

Lower spread of values = lower volatility.

**What does a high SD indicate?**

Higher spread of values = higher volatility.

**What does an SD of 2 mean?**

1 SD = 2% either way.

2 SD = 4% either way.

3 SD = 6% either way.

**SD Example with a Mean of 10%**

1 SD = return of 8% - 12%

2 SD = return of 6% - 14%.

3 SD= return of 4% - 16%.

**SD Even Distribution**

Same amount above/ below mean = Bell curve

**Limitations of SD**

Doesn’t compare to anything else.

Just own average return- unlike beta etc.

**Correlation Coefficients**

Strength of relationship in relative movements of two variables.

**Correlation Coefficients: Range**

-1 negative

0 Neutral

+1 Positive

**Correlation Coefficients: Positive**

One event causes similar movements of both variables.

Both Up/ Both Down

**Correlation Coefficients: Negative**

One event causes opposite movements of both variables.

One Up/ One Down

**Correlation Coefficients: Limited**

One event has little impact on movements of both variables.

**Weak Correlation Coefficient**

0.1 or - 0.1

**Perfect Correlation Coefficient**

1. - 1.0

**Correlation Coefficient as %**

1. = Assets will move 100% in line.

0.7 = Assets will move 70% in line.

**What type of assets provide the best form of diversification?**

Negatively correlated.

Difficult to find in reality.

**Efficient Frontier Graph**

Max return for a given level of risk.

Or

Lowest risk for a given return.

**Efficient Frontier Graph: why does curve flatten?**

There is a limit to risk/reward trade off.

**What if a portfolio doesn’t sit on the frontier curve?**

Not maximising returns for the level of risk its taking.

AVOID.

**Efficient Frontier Graph: Can you have portfolio’s above the line?**

No – Efficient Frontieris the ceiling.

**Efficient Frontier: Assumptions**

Investors are rational: want to avoid risk.

Investors cant influence prices.

Investors can borrow at risk free rate.

**What does Beta measure?**

Assets volitivity compared to whole market.

**Beta Figures**

Whole Market: 1

More Volatile: 1>

Less Volatile: <1

**Volatile Stocks**

Mining

Luxury goods

**Example: Beta as a % - 1.2% & 0.8%**

1.2% = 20% more volatile than whole market.

0.8% = 20% less volatile than whole market.

**Capital Asset Pricing Model (CAPM) Formula**

Expected Return = (Market Premium x Beta) + Risk Free Rate.

**Market Premium Formula**

Return on Market – Risk Free Rate

ROM- RFR

**What does Market Premium measure?**

Benefit in investing in the whole market as opposed to T-Bills etc.

**Return On Market**

Expected return if invested in whole market.

**Risk Free Rate**

Expected return from T-Bills

**What does CAPM provide?**

Expected return of an asset based on its beta.

**CAPM Disadvantages**

One factor model: less reliable.

Beta = past performance.

**Fama French 3 Factor Model**

Based on CAPM

Includes Company Size and Value Risk.

**Arbitrage Pricing Theory**

Uses macroeconomic data: inflation, unemployment etc.

**Efficient Market Hypothesis**

Share prices reflect all available information.

**Implication of Efficient Market Hypothesis**

Can’t find a bargain and consistently outperform the market.

Therefore > low fee tracker funds.

**Efficient Market Hypothesis: How to get higher returns?**

Seek out riskier investments.

**Efficient Market Hypothesis: Where does generally apply?**

Developed, regulated markets : US, Europe, Japan.

Less so in developing markets.

**Weak Form EMH**

All past price/ data is already fully reflected in current stock price.

Therefore > Technical analysis of trends/charts won’t work.

**Semi-Strong EMH**

Market reflects all Publicly Available Info.

New info- earnings reports- quickly reflected in price.

**Strong EMH**

Market is totally efficient.

Reflects all public/ private info.

**Limitations of EMH**

Not all investors have same info

Not all investors rational

Being to interpret data is equally as important .

**Behavioural Finance**

How psychological influences/biases affect investor behaviour.

**Loss Aversion**

Investors are more fearful of losing than making gains.

**Examples of Loss Aversion**

Holding onto losing stocks to long- don’t want to crystallise loss.

Selling growing investment to quickly.

**Overconfidence Bias**

People overestimate their skills/ intellect.

**Examples of Overconfidence Bias**

Over exposure to risk.

Illusion of control.

Under-reaction if things go badly.

**Hindsight Bias**

e.g. I saw 2007 crisis coming.

**Confirmation Bias**

Seek out info/ data that validates your existing beliefs.

**Framing Bias**

Make decisions on how info is framed rather than underlying details.

**Narrative Fallacy**

Where you create a story to explain a series of events.

Oversimplify complex factors.

e.g. linking success of firm to charismatic CEO – not economic conditions/ market trends.