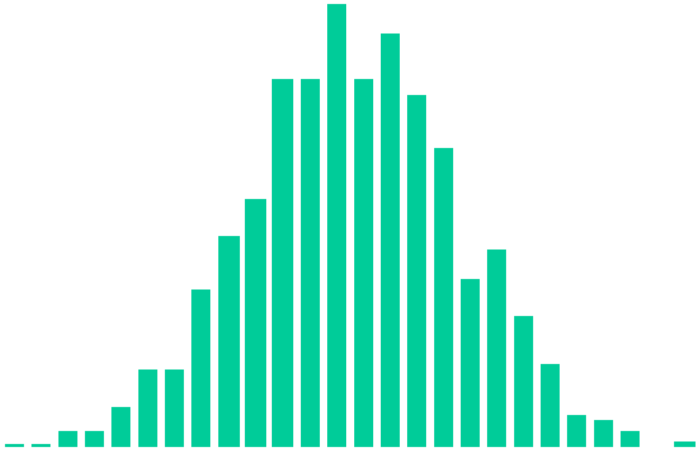
Chapter 7: Risk & Return



A Simple Bet?

Option A

- Heads you lose \$10 million
- Tails you win \$12 million
- Expected payoff is .5 x \$12 - .5 x \$10 = \$1 million

Option B

- Guaranteed \$1 million

A Simple Bet?

Scenario 2

- Tails you win $12 million
- Heads you lose $?? million

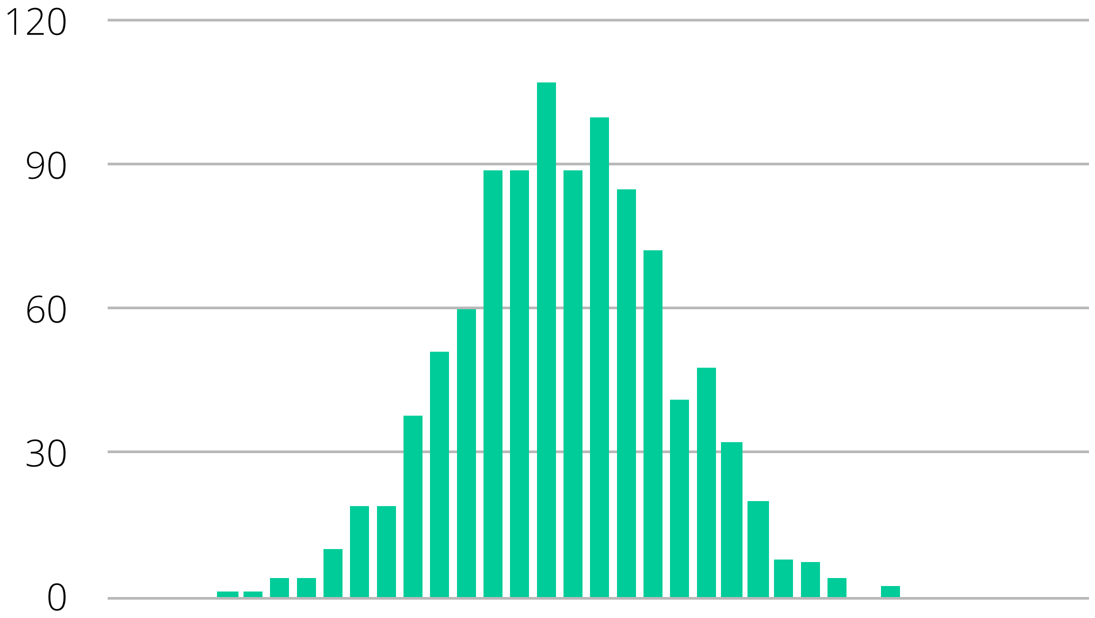
Scenario 3

- Tails you win $12
- Heads you lose $10

What is Risk?

- *Risk* is the probability of the unexpected.
  - How likely is the outcome?
  - How unexpected is the outcome?
- Individuals have different **risk preferences**.
  - **Risk averse**: Higher risk ➟ Higher return
  - Risk neutral: Higher risk ➟ No change
  - Risk seeking: Higher risk ➟ Lower return
- Preferences imply a quantitative trade-off between risk and return.

Quantifying Risk & Return



Measuring Risk

- **Mean** is the "expected" outcome—the average.

$$E[r] = \mu = p_1 r_1 + \ldots + p_N r_N$$

- **Variance** is related to the expected deviation from the mean.

$$var[r] = \sigma^2 = [p_1(r_1 - E[r]) + \ldots + p_N(r_N - E[r])]^2$$

- **Standard deviation** is the square-root of variance.

$$stdev[r] = \sigma$$

Estimating Risk

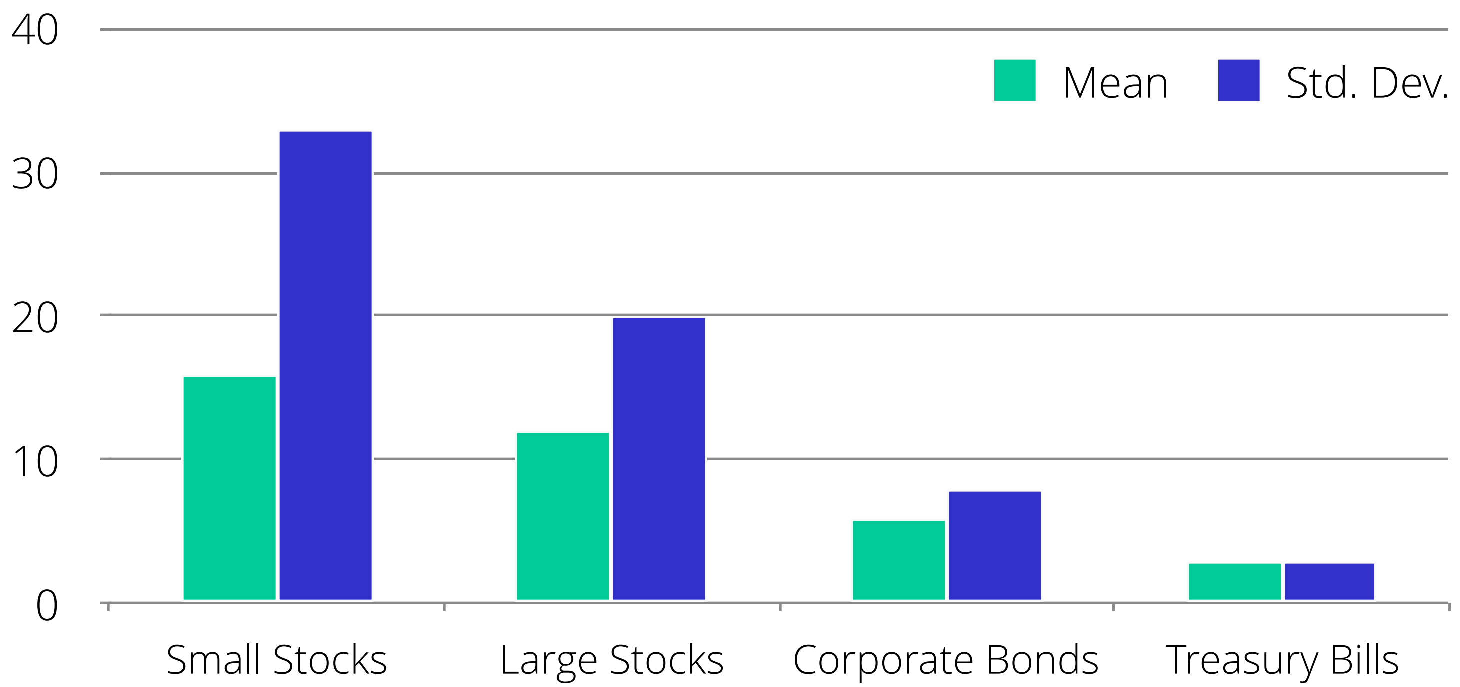
- We use historical data to estimate the mean and standard deviation.
- Assume each observation is a equally likely (P_i = 1/N).
- The mean is estimated by

$$E[r] \approx (1/N)r_1 + \ldots + (1/N)r_N$$

- Variance is estimated by

$$var[r] \approx [(1/N)(r_1 - E[r]) + \ldots + (1/N)(r_N - E[r])]^2$$

Historical Risk & Return

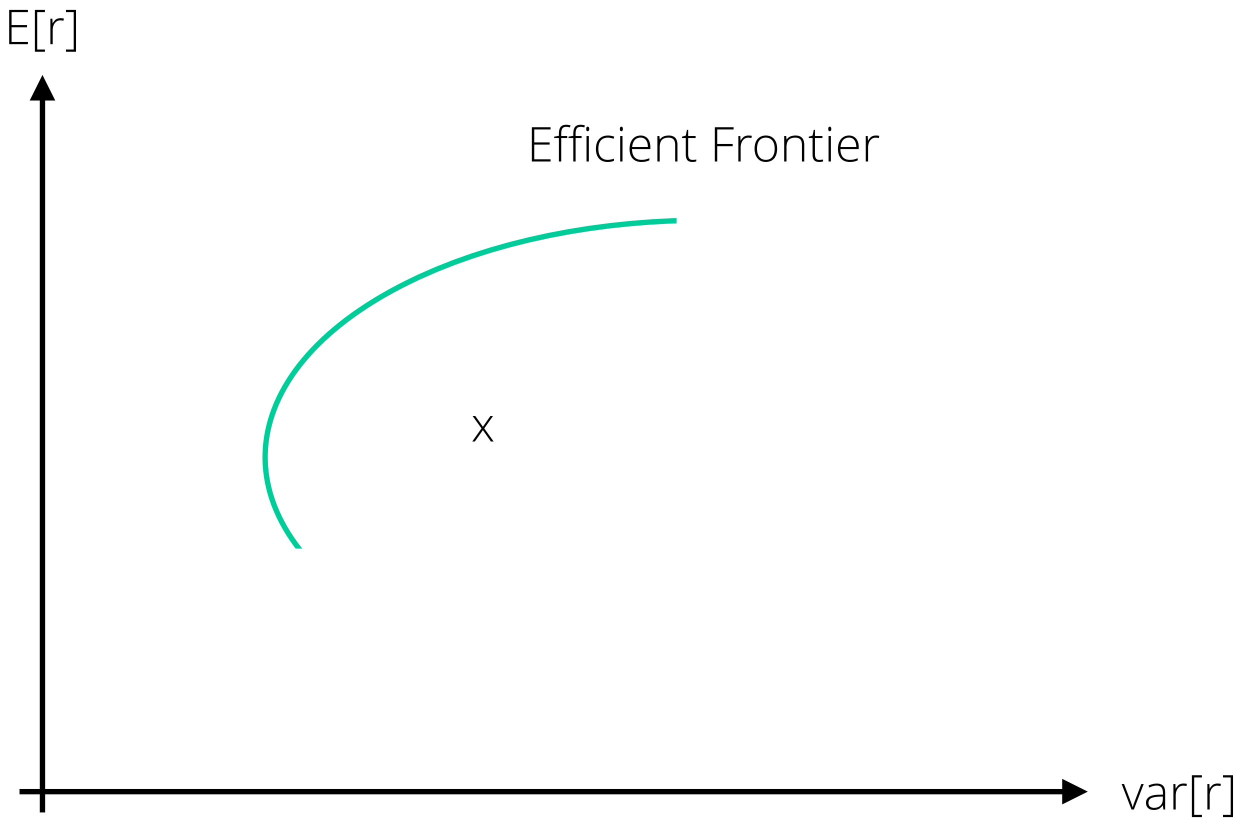


Decision Rules

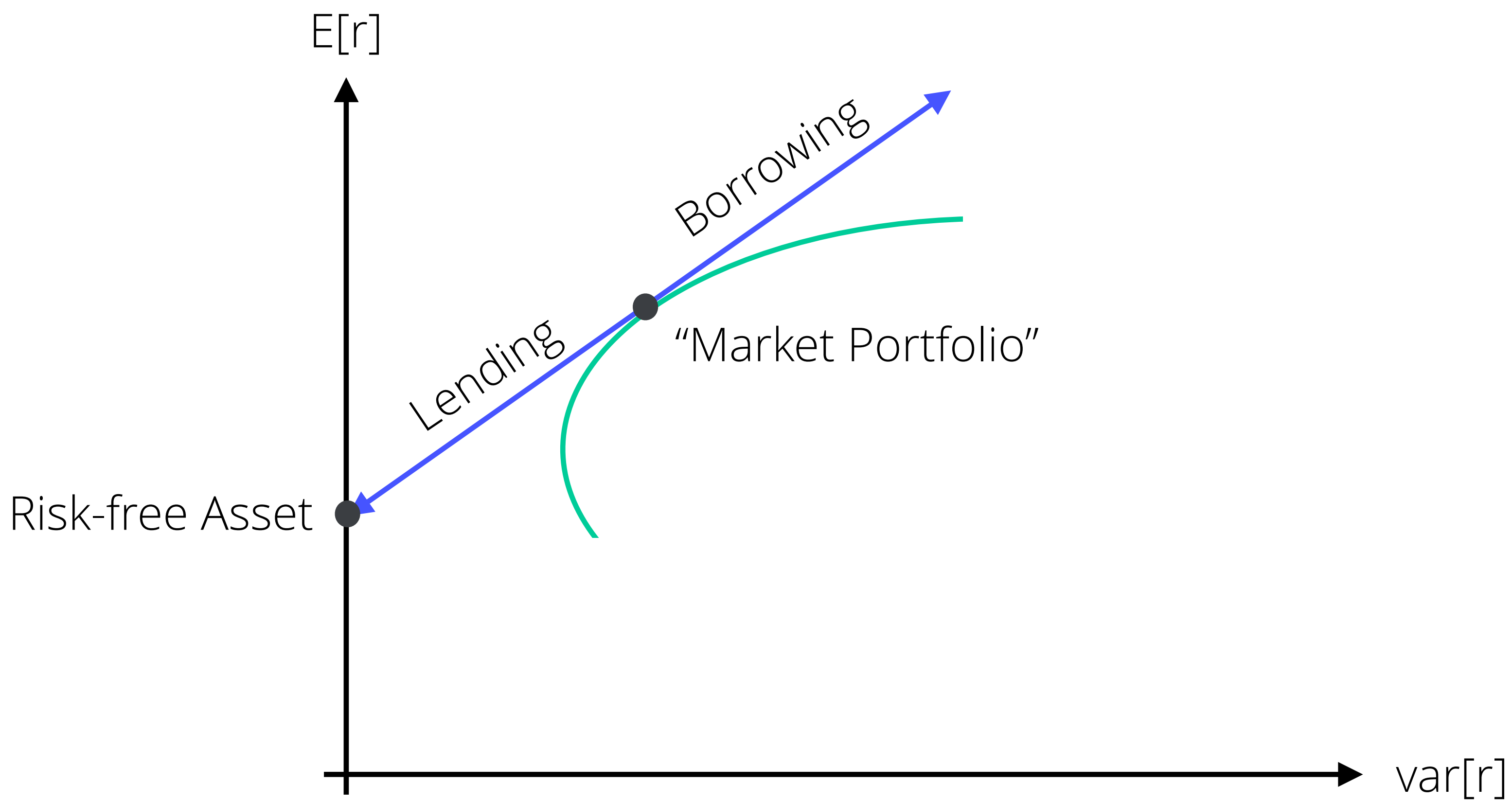
1. **Return maximization**: For a given level or risk (standard deviation), choose the highest return (mean).
2. **Risk minimization**: For a given level or return (mean), choose the lowest risk (standard deviation).

- Either decision rule leads to the same “efficient frontier” of assets/portfolios.

Decision Rules



Decision Rules



Decision Rules

- Investors only need to decide how much to invest in the market portfolio (w_{mkt}) and how much to put in the risk-free asset.
- The mean of the portfolio is

$$E[r_p] = w_{mkt} \times E[r_{mkt}] + (1 - w_{mkt}) \times r_{rf}$$

- The standard deviation of the portfolio is

$$\sigma_p = w_{mkt} \times \sigma_{mkt}$$

Portfolio Risk

Stock	Investment ($)	Investment (%)	Expected Return	Variance
GM	2.7	25%	7%	0.6
CSCO	1.5	14%	12%	1.5
DE	3.0	28%	8%	0.4
WY	1.2	11%	7%	0.8
PG	2.5	23%	9%	0.6
Portfolio	10.9	100%	8.4%	69.1%

Portfolio Risk

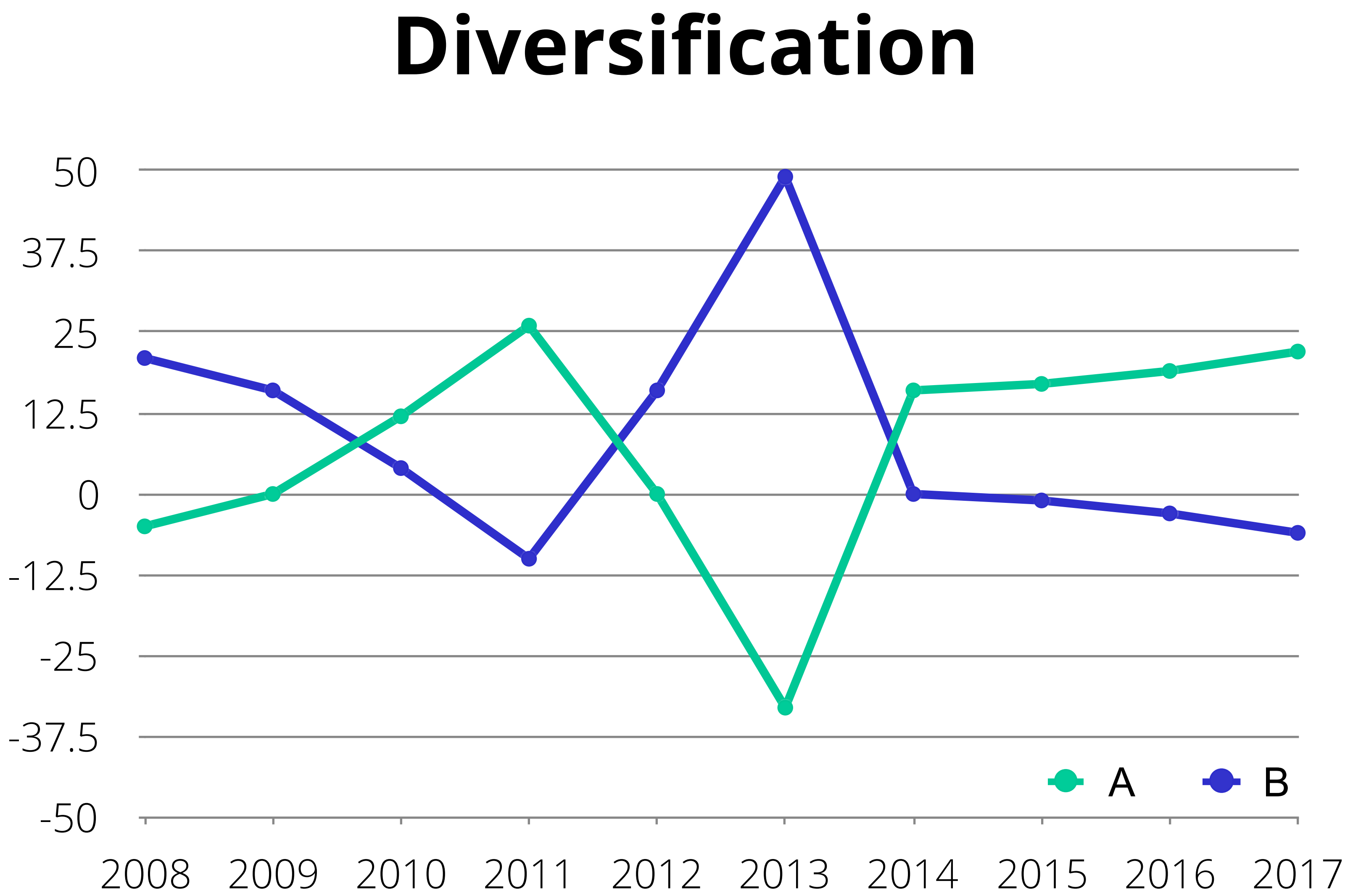
- Portfolio means are weighted averages:

$$E[r_p] = w_1\ E[r_1] + \ldots + w_N\ E[r_N]$$

- Adding a high (low) return stock to a portfolio increases (decreases) the portfolio mean return.
- Portfolio variances are **not** weighted averages!

$$\text{var}[r_p] \neq w_1\ \text{var}[r_1] + \ldots + w_N\ \text{var}[r_N]$$

- The effect of adding a high (low) variance stock to a portfolio does not necessarily increase (decrease) the portfolio variance.


Diversification
50
37.5
25
12.5
0
-12.5
-25
-37.5
-50
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
A
B

Diversification

	Stock A	Stock B	Portfolio (A+B)
2008	-5	21	8
2009	0	16	8
2010	12	4	8
2011	26	-10	8
2012	0	16	8
2013	-33	49	8
2014	16	0	8
2015	17	-1	8
2016	19	-3	8
2017	22	-6	8
Mean	**7**	**9**	**8**
Std. Dev.	**18**	**18**	**0**

Diversification

- By themselves, the stocks are not that appealing.
  - High risk, modest return (low ➟ price).
- As a portfolio, they make an attractive investment.
  - If you bought them both, you made 8% every year!
  - Low risk, modest return (high ➟ price).
- Suggests two prices for the stocks. Which price prevails in the market?

Diversification

- **Example** Invest $50 in Stock A and $50 in Stock B. What are the risk and return of the portfolio?

Diversification

- Assume we have N assets with equal weights invested in each.
- The portfolio mean is

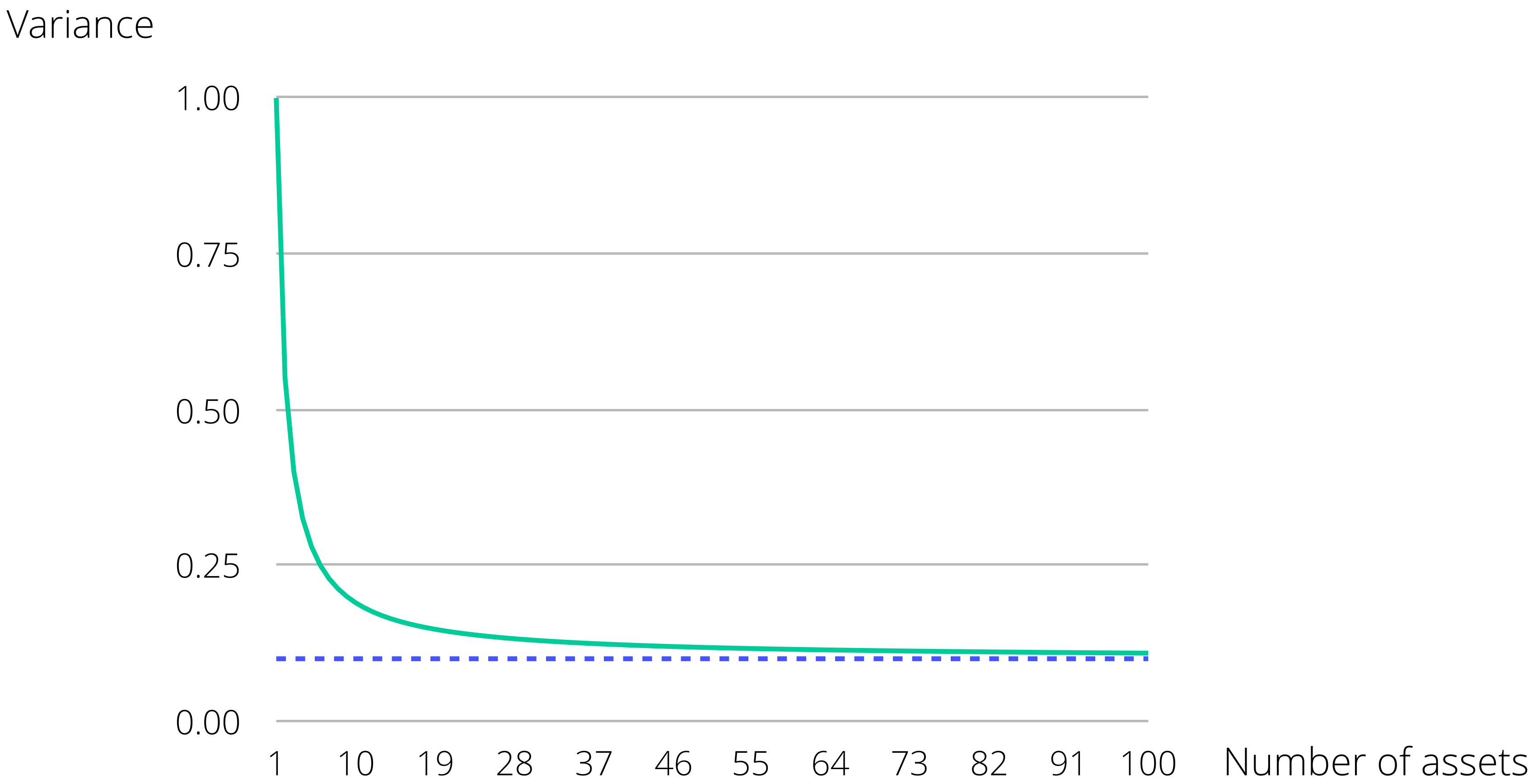
$$E[r_p] = (1/N)\, r_1 + \ldots + (1/N)\, r_N$$

- The portfolio variance is

$$\mathrm{var}[r_p] = (1/N)\, E[\mathrm{var}[r_i]] + (N\text{-}1)/N\, E[\mathrm{cov}[r_i, r_j]]$$

- As the portfolio gets big, only the covariance matters.

Diversification



Diversification

- **Firm-specific (idiosyncratic) risk** is risk that can be diversified away.
  - For example, the risk that a factory catches on fire is uncorrelated with the rest of the market.
  - As the number of assets in a portfolio increases, this risk becomes irrelevant.
- **Systematic (market) risk** is risk that cannot be diversified away.
  - It depends on how the asset relates to the rest of the assets in the portfolio.

Implications of Diversification

- "Efficient" investors own a combination of the risk-free asset and the market portfolio.
- These investors should primarily care about the covariance of each security with the rest of the market portfolio.
  - The firm-specific risk is diversified away ("for free").
- Therefore, asset returns should reflect their systematic risk.