

## UNIVERSITY OF TEXAS AT AUSTIN

## Quiz # 18

More on diversification. More on the CAPM.

Please, provide your **final answers only** to the following problems:

**Problem 18.1.** (2 points) *Source: Course 2, May 2003, Problem #11.*

The variability of an investment portfolio that is balanced evenly between two stocks is lower than the average variability of the two individual stocks. *True or false?*

**Solution: TRUE**

**Problem 18.2.** (2 points) *Source: Course 2, May 2003, Problem #11.*

Full diversification of an investment portfolio eliminates market risk. *True or false?*

**Solution: FALSE**

**Problem 18.3.** (2 points) Under the **CAPM**, the expected return and the required return of the market portfolio are equal. *True or false?*

**Solution: TRUE**

**Problem 18.4.** (5 points) *Source: Course 2, November 2002, Problem #36.*

Jack has an equally weighted portfolio of stocks X and Y. The beta of his portfolio is 0.9. Jill has an equally weighted portfolio of stocks X, Y, and Z. The beta of stock Z is 1.2, the Treasury bill rate of return is 6%, and the expected return on the market portfolio is 14.4%. What is the expected risk premium on Jill's portfolio?

- (a) 6.0%
- (b) 7.6%
- (c) 8.4%
- (d) 8.8%
- (e) 10.1%

**Solution: (c)**

The  $\beta$  of Jack's portfolio is

$$\beta_1 = \frac{1}{2}(\beta_X + \beta_Y) = 0.9 \quad \Rightarrow \quad \beta_X + \beta_Y = 1.8$$

The  $\beta$  of Jill's portfolio equals

$$\beta_2 = \frac{1}{3}(\beta_X + \beta_Y + \beta_Z) = \frac{1}{3}(1.8 + 1.2) = 1.$$

Note that the  $\beta$  of Jill's portfolio equals the  $\beta$  of the market portfolio. So, her expected risk premium is

$$0.144 - 0.06 = 0.084.$$

**Problem 18.5.** (5 points) For a certain stock, you are given that its expected return equals 0.12 and that its  $\beta$  equals 1.2. For another stock, you are given that its expected return equals 0.07 and that its  $\beta$  equals 0.4. Both stocks lie on the **Security Market Line (SML)**. What is the risk-free interest rate  $r_f$ ?

- (a) 0.04
- (b) 0.045
- (c) 0.0625
- (d) 0.1075

(e) None of the above.

**Solution: (b)**

Denote the expected return of the market portfolio by  $r_m$ . Then,

$$0.12 = r_f + 1.2(r_m - r_f),$$

$$0.07 = r_f + 0.4(r_m - r_f).$$

Subtracting the second equation from the first one, we get

$$0.05 = 0.8(r_m - r_f) \Rightarrow r_m - r_f = \frac{0.05}{0.8} = 0.0625.$$

Substituting the obtained risk premium of the market portfolio into the first equation above, we obtain

$$r_f = 0.12 - 1.2(0.0625) = 0.045.$$