Contents

Foreword IX

List of Symbols and Acronyms XI

1. Introduction to Portfolio Analysis: Key Notions 1

1. Financial Securities 1
    1.1 Definition of financial securities 1
    1.2 Computing the return of financial securities 3
2. Choices under Risky Situations 5
    2.1 Choices under uncertainty: a general framework 5
    2.2 Complete and incomplete criteria of choice under uncertainty 7
3. Statistical Summaries of Portfolio Returns 11
    3.1 Portfolio mean 14
    3.2 Portfolio variance and standard deviation 15

References and Further Readings 20

2. Choice under Uncertainty and State-Preference Approach to Portfolio Decisions 23

1. Representing Preferences and Risk Aversion Attitudes with Utility Functions 23
    1.1 Choice under certainty: preference relations 23
    1.2 The expected utility theorem 27
2. Measuring Risk Aversion and Its Economic Implications 35
    2.1 Risk aversion and the concavity of the utility function 35
    2.2 Measuring risk aversion 39
    2.3 Absolute and relative risk aversion measures and acceptable odds of a bet 41

2.4 Absolute and relative risk aversion coefficients and the size of the risk premium 44
3. A Review of Commonly Used Utility of Wealth Functions 51
References and Further Readings 56
Appendix A 57
Appendix B 58

3. Introduction to Mean-Variance Analysis 61

1. The Opportunity Set and the Efficient Frontier (No Riskless Borrowing and Lending) 61
    1.1 The efficient frontier with two risky securities 63
    1.2 The efficient frontier with N risky securities 73
2. The Opportunity Set and the Efficient Frontier (with Riskless Borrowing and Lending) 81
3. Efficient Frontier under Short-Selling Constraints. 88
References and Further Readings 92
Appendix A 92
Appendix B 94
A Worked-Out Excel Example 94

4. Optimal Portfolio Selection: A Few Analytical Results 99

1. Risk Aversion and the Canonical Portfolio Problem 99
    1.1 When will risky assets be demanded? 101
    1.2 A few comparative statics results 106
    1.3 A second two-fund separation result: Cass-Stiglitz's theorem 109
2. Aversion to Risk and Optimal Portfolio Selection in the Mean-Variance Framework 113
    2.1 Mean-variance preference representations: pros and cons 113
    2.2 Indifference curves in mean-variance space 117
    2.3 Optimal mean-variance portfolios 119
3. Increasing Risk and Stochastic Dominance Criteria 123
    3.1 First-order stochastic dominance 124
    3.2 Second-order stochastic dominance 127
References and Further Readings 132
A Worked-Out Excel Example 132

5. Mean-Variance Theory at Work: Single and Multi-Index (Factor) Models 137

1. The Inputs to Mean-Variance Analysis and the Curse of Dimensionality 137
    1.1 Asset pricing models as a way to recover mean-variance inputs 141
2. The Single-Index Model and Its Relationship with the Classical CAPM 144
    2.1 Relationship with the CAPM 153
    2.2 Practical implementation: conditional vs. unconditional inputs 157
    2.3 Summary of the model 159
    2.4 Determining the MV frontier under the single-index model 160
3. Multi-Index Models and Their Relationship with the APT 164
    3.1 Can macroeconomic factors help in mean-variance analysis? 174
    3.2 How does one orthogonalize factor series? 175
    3.3 Relationship with the Arbitrage Pricing Theory (APT) 181
    3.4 Which factors among many? 182
    3.5 Getting a top-down handle on factor exposures 185
    3.6 Summary of the model 192

References and Further Readings 193

6. Human Capital, Background Risks, and Optimal Portfolio Decisions 197

1. Simple Approaches to Labor Income in Portfolio Decisions 197
    1.1 Taking a "first stab": the case of deterministic, riskless labor income 200
    1.2 A first formal, one-period stochastic model 203
2. The Case of Constant Relative Risk Aversion Preferences 208

References and Further Readings 217

7. Performance Measurement and Attribution 219

1. Generalities 219
2. Simple Performance Measures 225
3. Decomposing Performance 232
    3.1 Market timing and tactical asset allocation 236
    3.2 Multi-index measures 238

4. Active vs. Passive Portfolio Management 240
References and Further Readings 243
A Worked-Out Excel Example 244