Introduction

• Harry Markowitz: Father of modern portfolio theory (MPT). His dissertation at the University of Chicago in 1952 “Portfolio Selection” will become the basis for his Nobel Prize in 1990.

MPT: would have been relevant 1000 years ago and it will be relevant 1000 years from now...

• Diversification: How to manage and reduce risk.
“Don’t put all your eggs in one basket!”

• Portfolio: a group of assets.

• Idea of diversification is not new. For example, in Shakespeare’s “Merchant of Venice” written around 1600 for someone that lived around 1400-1500, the merchant Antonio was asked why he was sad. Antonio was asked “is your business not doing so well”? And Antonio replied:

My ventures are not in one bottom trusted,  
Nor to one place; nor is my whole estate  
Upon the fortune of this present year;  
Therefore, my merchandise makes me not sad


• Before 1952 the fact that stocks are correlated was not taken into account.

• This course is not about which stocks to select. Not an easy question!

• Given a set of stocks we wish to find the optimum combination of these stocks that will minimize risk.

• It is an optimization problem: It can be solved easily under different conditions and assumptions.

• We will discuss several models:
  1. Classical Markowitz model.
  2. Single index model.
  3. Constant correlation model.
  4. Multi-group model.
  5. Multi-index model.

Short sales not allowed, short sales allowed, and investors have access to the risk free asset.
• By the end of the 5th week we will be able to test the performance of the various portfolios and compare them with the market:

![Graph showing returns over time for different portfolios]

• The R package `stockPortfolio` will be used extensively throughout the course. Please download R from [http://cran.stat.ucla.edu/](http://cran.stat.ucla.edu/). Then at the R command line type:

```r
> install.packages("stockPortfolio")
```

To load the package into R type:

```r
> library(stockPortfolio)
```

• It helps to be familiar with: Random variables, expected value and variance of a random variable, mean and variance of a sum of random variables, covariance and correlation, simple and multiple regression, differentiation, maximizing or minimizing a function subject to a set of constraints, basic analytic geometry, basic linear algebra, statistical inference ($\chi^2$, $t$, $F$) distributions.

• Stock market data will obtained from [http://finance.yahoo.com/](http://finance.yahoo.com/) and we will mainly use monthly close prices. The package `stockPortfolio` can get close prices for stocks listed in NYSE and NASDAQ from this website and convert them into returns. The package can also read data supplied by the user.

• Objectives of a portfolio analysis: Depends on the investor. But two objectives are common for all investors:

1. They want “return” to be high: prefer more than less.
2. They want this return to be stable, not subject to uncertainty (risk).

This material is not for investors who prefer uncertainty!

• However, the highest return portfolio is associated with the highest uncertainty (risk) and the lowest uncertainty (risk) is associated with lowest return. Between these two extremes we find “efficient portfolios”.

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