

Nine Major Steps in Modern Portfolio Theory

Topics 5a and 5b

1. Summarize characteristics of a single security: risk and return
2. Summarize characteristics of a two security portfolio: importance of covariance
3. Risk and return trade-off for a two security portfolio: shape of portfolio possibility locus (opportunity set) as a function of correlation
4. Choose an optimal portfolio: indifference curves combined with portfolio possibility trade off
5. Generalize to many securities: introduce systematic vs. nonsystematic risk (also see BKM for this)
6. Introduce a risk free security: create capital allocation line

Topic 6

7. Implications of steps 1-6 for the equilibrium structure of returns on risky securities: explaining excess returns above the risk-free rate
8. Simplify structure of returns with beta
9. Applications to evaluating portfolio performance (see BKM for this)