Lecture Notes 6

Asset Allocation: Risky vs. Riskless

I. Readings and Suggested Practice Problems

II. Expected Portfolio Return: General Formula

III. Standard Deviation of Portfolio Return: One Risky Asset and a Riskless Asset

IV. The Asset Allocation Framework

V. The Capital Allocation Line

VI. Portfolio Management: One Risky Asset and a Riskless Asset

VII. Additional Readings

Buzz Words: Reward to Variability Ratio, Separation Theorem, Portfolio’s Risk Adjustment, Portfolio Management
I. Readings and Suggested Practice Problems

BKM, Chapter 7
Suggested Problems, Chapter 7: 8, 18-23.

A useful example from the Additional Readings:

**Investment Advice from Wall Street**

Two annual recommendations from Morgan Stanley (as reported in the WSJ)

<table>
<thead>
<tr>
<th></th>
<th>Stocks % in Complete Port. [% in the risky part]</th>
<th>Bonds % in Complete Port. [% in the risky part]</th>
<th>Cash % in Comp</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>65 [81.25]</td>
<td>15 [18.75]</td>
<td>20</td>
</tr>
<tr>
<td>Year 2</td>
<td>80 [80]</td>
<td>20 [20]</td>
<td>0</td>
</tr>
</tbody>
</table>

In this and subsequent lectures, we want to understand:

- How to chose the relative weights, in [brackets] above, of “Stocks” and “Bonds” (or any other two risky assets that make up the risky portion of your complete portfolio).

- What is the role of “Cash” (i.e., the riskless asset within the portfolio, such as a money market account).