

Study Plan

Chapter 7

Learning Objectives

After studying this chapter you will be able to:

- Illustrate three different approaches for estimating an asset's expected return;
- Calculate a portfolio's expected return and its beta;
- Show how the Capital Asset Pricing Model (CAPM) links an asset's beta to its expected return; and
- Describe the concept of market efficiency and its important lessons for investors.

Summary and conclusions

- Investors and managers must make decisions based on expected returns.
- Estimates of expected returns may be obtained from historical data, from probabilistic calculations, or from a risk-based approach.
- An asset's beta measures its systematic risk, and it is this risk that should be linked to expected returns.
- The expected return of a portfolio equals a weighted average of the expected returns of the assets in the portfolio. The same can be said of the portfolio's beta.
- The standard deviation of a portfolio usually does not equal the weighted average of the standard deviation of the shares in the portfolio. This is because some of the unsystematic fluctuations of individual shares cancel each other out in a portfolio. A fully diversified portfolio contains only systematic risk.
- The CAPM predicts that the expected return on a share depends on the share's beta, the risk-free rate, and the market risk premium.
- In an efficient market, competition for information makes asset prices nearly unpredictable.