

MPT: Markowitz

CAPM: Sharpe fundamental notions1. Notion of Risk:

Riskiness is measured by the variability of returns.

Let's take an example to understand this.

5 year return given

Share M: 30%, 28%, 34%, 32% and 31%

Share N: 26%, 13%, 48%, 11% and 57%

Average Return:

$$\text{Sh. M: } (30 + 28 + 34 + 32 + 31) / 5 = 31\%$$

$$\text{Sh. N: } (26 + 13 + 48 + 11 + 57) / 5 = 31\%$$

So, which share would you choose to invest in?

You are at fix!!!

But, 2 things come to mind

(i) Expected Return (?)

(ii) Riskiness of Return. (?)

To a great extent, Sh. M. shows steady return and Sh. N shows great variability i.e. rise and fall is too sharp.

Hence, Sh. N is a risky asset; and investor would prefer Sh. M to Sh. N.

