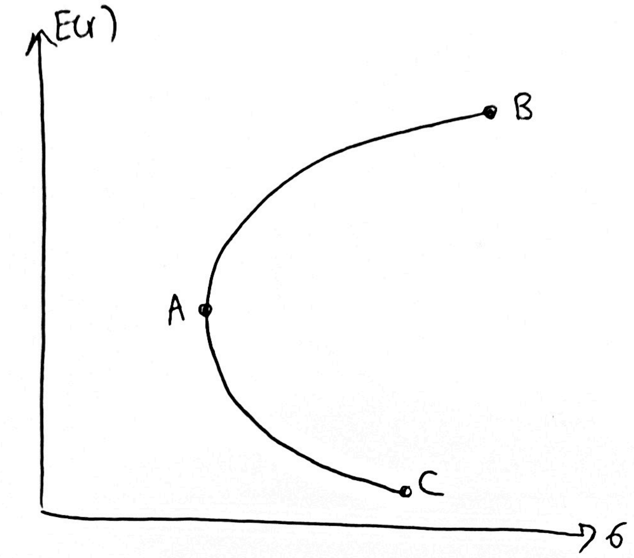
FN 312

Quiz 2 Answer key

① a)

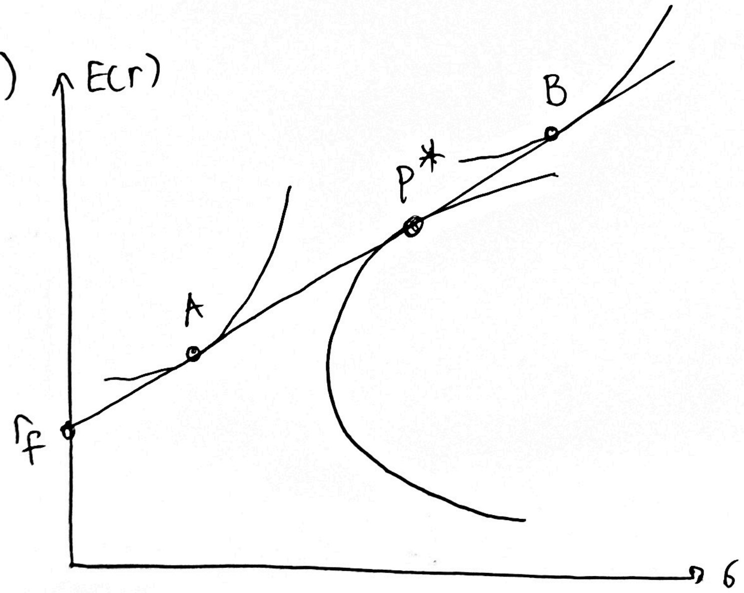


AB efficient parts

AC inefficient parts

A global minvar portfolio

b)



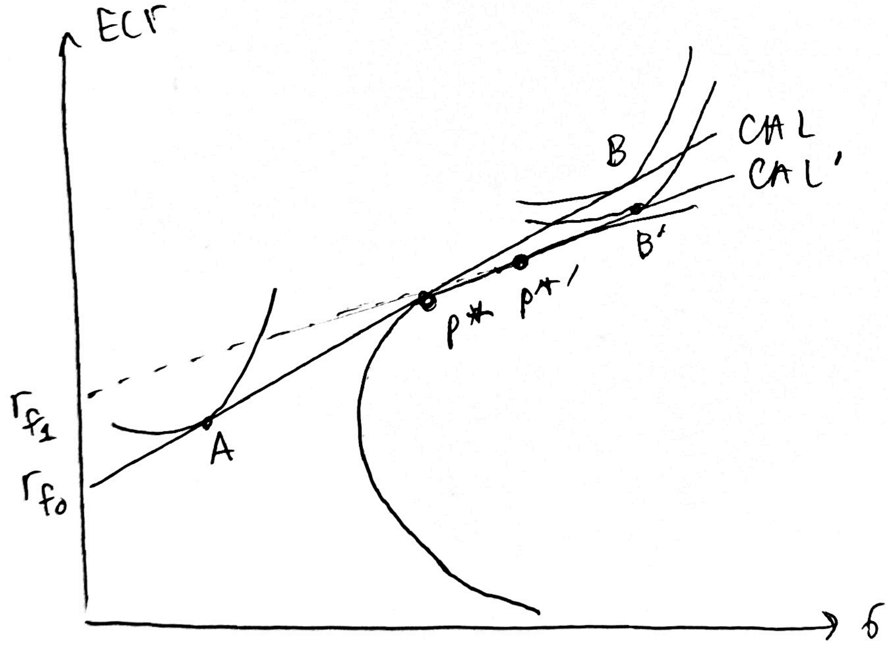
P* optimal risky portfolio

A is ~~mo~~ relatively more risk averse than B

(no need to draw indifference curves for full credit

c) The answer in part b) satisfies the two fund seperation theorm since both investors have the same optimal risky portfolio P* regardless of their levels of risk aversion. Risk preferences only come into play when they choose the optimal complete portfolio which is different for A and B (Because A is more risk averse, he invests more in the risk free asset).

d)



If the borrowing rate increases from r_{f0} to r_{f1} only B will be affected as the original CAL is still valid in the lending portion, (but becomes less steep in the borrowing portion) which results in a less optimal complete portfolio B' (lower expected return for same risk) for investor B who is borrowing.