FIN 366: INVESTMENTS
OPTIMAL RISKY AND COMPLETE PORTFOLIO
CRITICAL THINKING & CONCEPTUAL QUESTIONS

1. Describe the two steps of portfolio construction defined by the separation property.
2. Why in theory is the optimal risky portfolio of two assets the same for everyone who holds those two assets, regardless of how risk averse they are?
3. You calculate that the optimal weights for the ABC stock fund and XYZ bond funds are 82% ABC and 18% XYZ. Does that mean the optimal weights for the ABC stock fund and the UVW bond fund are also 82% and 18%?
4. How are the optimal risky asset weights determined? (Hint: look to the end notes of this section. Answer in *very broad* terms, no need to be overly technical).
5. Why would choosing to hold risky assets with weights different than what we compute be suboptimal?
6. Why is choosing *any* combination of the optimal risky portfolio and the risk-free asset as good as any other combination of the optimal risky portfolio and the risk-free asset?
7. Why are the correlations between two risky assets an important input in determining the optimal weights in the risky portfolio?
8. How can you determine graphically where the optimal risky portfolio is on an investment opportunity set of two risky assets?
9. How is it possible for the complete portfolio to be off the investment opportunity set of two risky assets? Will it always be off this investment opportunity set?
10. What will happen to the weights we hold in two risky assets as the expected returns, standard deviations, and correlations change through time?
11. CHALLENGE Describe the difference between the (1) investment opportunity set created between the risk-free asset and a risky portfolio and the (2) investment opportunity set created between two risky assets. What do the shapes of these different "IOSs" generally look like? How does an investor move along these different IOSs?
12. CHALLENGE In our examples, we've considered a stock fund and a bond fund as our two risky assets. Assume that the stock and bond funds are both actively managed. In broad terms, describe what happens to our illustrations of the IOS of risky portfolios and the capital allocation line as the fund managers change the composition of their funds.