



FIN 366: INVESTMENTS

CRITICAL THINKING & CONCEPTUAL QUESTIONS

Chapter 7:

1. What is a positive alpha stock? A negative alpha stock?
2. How (in theory) are alphas eliminated as investors buy and sell positive and negative alphas?
3. An implication of buying and selling pressures forcing alphas to be zero means there is no reward for unsystematic risk. Where does our reward come from then?
4. How does an index fund or portfolio eliminate diversifiable risk?
5. What is the market risk premium?
6. By the CAPM, what do we need in order to compute the expected return on a stock?
7. How might we find a stock's beta (other than by looking it up online?)
8. Where do we obtain the expected return for the market?
9. Why do we need all of these investor behavior and market structure assumptions for the CAPM?
10. If every investor held a passive market index portfolio, what would happen to market efficiency?
11. What is included in the market portfolio for the CAPM?
12. Why is there no alpha in the CAPM formula?
13. Can you draw and label the SML?
14. Where would you find under- and over-valued stocks on the SML graph?
15. How is the CAPM employed in real-world settings?
16. If the CAPM isn't perfect, why do we learn about it?
17. What are "quintiles" of stocks?
18. Have high-beta stocks outperformed low-beta stocks as the CAPM predicts? Why does the CAPM predict high-beta stocks will outperform low-beta stocks?
19. In what way do multifactor models improve over the performance of the CAPM?

20. Why does the Fama-French 3-factor model specifically consider size and value?
21. If small stocks and value stocks have historically outperformed large and growth stocks, why don't we always just hold small and value stocks?
22. As we add more factors to the CAPM, what happens to alphas we calculate?
What does this imply?
23. As we add more factors to the CAPM, what happens to the R-squared?
What does this imply?
24. Morningstar presents alphas on their website for different mutual funds.
How are these alphas computed? Is there a better way?

