

Bodie, Kane, Marcus p. 265

21. Consider the following data for a one-factor economy. All portfolios are well diversified.

Portfolio A	$E(r_A) = 10\%$	$\beta_A = 1.0$
Portfolio F	$E(r_F) = 4\%$	$\beta_F = 0$
Portfolio E	$E(r_E) = 9\%$	$\beta_E = 2/3$

Would an arbitrage strategy exist? If so, what would the arbitrage strategy be?

Ok, there are a few ways that you could go about solving this one. Basically the idea is to see if you can construct a zero beta portfolio that has a higher rate of return than the risk-free asset.

So a few things that you might notice.

$$E(r_F) = r_f + \beta_F(E(r_M) - r_f) = r_f = 4\%, \text{ since } \beta_F = 0$$

$$E(r_A) = r_f + \beta_A(E(r_M) - r_f) = E(r_M) = 10\%$$

Then we can use this to figure out whether the α for portfolio E is zero. The formula is:

$$\alpha_E = (E(r_E) - r_f) - \beta_E(E(r_M) - r_f) = (9 - 4) - (2/3)(10 - 4) = 1\%$$

So the alpha is positive which implies that the portfolio is undervalued. So there is an arbitrage opportunity and we can exploit this by buying this portfolio. But we can say more. We can construct the zero-beta portfolio, using portfolios A and E.

$$w_A = (-\beta_E) / (\beta_A - \beta_E) = -2, \quad w_E = (\beta_A) / (\beta_A - \beta_E) = 3$$

So, we should sell short 2 units of A, and buy 3 units of E.
It is easy to verify that the beta for this new portfolio is zero:

$$\beta_{w_A w_E} = \beta_A w_A + \beta_E w_E = 0$$

Also we can show that the return on this portfolio is:

$$E(r_{w_A w_E}) = r_f + \alpha_A w_A + \alpha_E w_E = 7\%$$

i.e. we can earn a 7% return on a risk-free asset.
Alternatively : $E(r_{w_A w_E}) = w_A E(r_A) + w_E E(r_E) = 7\%$

So our arbitrage strategy is to short portfolio F (borrow at 4%) and then invest in this new portfolio which earns 7%. Then we retire to the Bahamas.

23. Assume both portfolios A and B are well diversified, that $E(r_A) = 14\%$ and $E(r_B) = 14.8\%$. If the economy has only one factor, and $\beta_A = 1.0$ while $\beta_B = 1.1$, what must be the risk-free rate?

This one's pretty easy, I think just about everyone got it. Just plug it in to the formula:

$$(E(r_A) - r_f) / (\beta_A) = (E(r_B) - r_f) / (\beta_B) \text{ and solve for } r_f = 6\%.$$

p. 331

Problem Set Solutions For Bodie Kane Marcus

Jianjun Gao



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Solutions Manual for Investments Alan J. Marcus, Professor,Alex Kane,Zvi Bodie, Professor,2013-09-17 This manual provides detailed solutions to the end of chapter problem sets

Economics and Finance ,2006

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portfolio the total risk of the portfolio decreases depending on the correlations of asset returns while the expected return on the portfolio represents the weighted average of the expected returns for each asset The book explains PSO in detail and demonstrates how to implement Markowitz's portfolio optimization approach using PSO In addition it expands on the Markowitz model and seeks to improve the solution finding process with the aid of various algorithms In short the book provides researchers teachers engineers managers and practitioners with many tools they need to apply the PSO technique to portfolio optimization

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Table of Contents Problem Set Solutions For Bodie Kane Marcus

1. Understanding the eBook Problem Set Solutions For Bodie Kane Marcus
 - The Rise of Digital Reading Problem Set Solutions For Bodie Kane Marcus
 - Advantages of eBooks Over Traditional Books
2. Identifying Problem Set Solutions For Bodie Kane Marcus
 - Exploring Different Genres
 - Considering Fiction vs. Non-Fiction
 - Determining Your Reading Goals
3. Choosing the Right eBook Platform
 - Popular eBook Platforms
 - Features to Look for in an Problem Set Solutions For Bodie Kane Marcus
 - User-Friendly Interface
4. Exploring eBook Recommendations from Problem Set Solutions For Bodie Kane Marcus
 - Personalized Recommendations
 - Problem Set Solutions For Bodie Kane Marcus User Reviews and Ratings
 - Problem Set Solutions For Bodie Kane Marcus and Bestseller Lists

5. Accessing Problem Set Solutions For Bodie Kane Marcus Free and Paid eBooks
 - Problem Set Solutions For Bodie Kane Marcus Public Domain eBooks
 - Problem Set Solutions For Bodie Kane Marcus eBook Subscription Services
 - Problem Set Solutions For Bodie Kane Marcus Budget-Friendly Options
6. Navigating Problem Set Solutions For Bodie Kane Marcus eBook Formats
 - ePub, PDF, MOBI, and More
 - Problem Set Solutions For Bodie Kane Marcus Compatibility with Devices
 - Problem Set Solutions For Bodie Kane Marcus Enhanced eBook Features
7. Enhancing Your Reading Experience
 - Adjustable Fonts and Text Sizes of Problem Set Solutions For Bodie Kane Marcus
 - Highlighting and Note-Taking Problem Set Solutions For Bodie Kane Marcus
 - Interactive Elements Problem Set Solutions For Bodie Kane Marcus
8. Staying Engaged with Problem Set Solutions For Bodie Kane Marcus
 - Joining Online Reading Communities
 - Participating in Virtual Book Clubs
 - Following Authors and Publishers Problem Set Solutions For Bodie Kane Marcus
9. Balancing eBooks and Physical Books Problem Set Solutions For Bodie Kane Marcus
 - Benefits of a Digital Library
 - Creating a Diverse Reading Collection Problem Set Solutions For Bodie Kane Marcus
10. Overcoming Reading Challenges
 - Dealing with Digital Eye Strain
 - Minimizing Distractions
 - Managing Screen Time
11. Cultivating a Reading Routine Problem Set Solutions For Bodie Kane Marcus
 - Setting Reading Goals Problem Set Solutions For Bodie Kane Marcus
 - Carving Out Dedicated Reading Time
12. Sourcing Reliable Information of Problem Set Solutions For Bodie Kane Marcus
 - Fact-Checking eBook Content of Problem Set Solutions For Bodie Kane Marcus
 - Distinguishing Credible Sources
13. Promoting Lifelong Learning

- Utilizing eBooks for Skill Development
- Exploring Educational eBooks

14. Embracing eBook Trends

- Integration of Multimedia Elements
- Interactive and Gamified eBooks

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