**Capital Market and Portfolio Management**

**NMIMS Centre for Distance and Online Education (NCDOE)**

**Internal Assignment Applicable for June 2025 Examination**

**Q1. David and Sarah, have different perspectives on how to measure risk and construct portfolios. David follows the Capital Market Line (CML) approach, believing that a well-diversified portfolio should be assessed based on total risk (standard deviation). He argues that the CML represents the best possible combination of risk and return, achievable only through a mix of the risk-free asset and the market portfolio. Sarah, however, trusts the Security Market Line (SML), insisting that risk should be measured by beta, which only considers systematic risk. How would you help David and Sarah resolve their debate? How does the Capital Market Line (CML) differ from the Security Market Line (SML) in terms of risk measurement and portfolio representation?**

**Answer:**

**Introduction:**

David and Sarah are both interested in understanding how to best measure risk and build an effective investment portfolio. However, they hold different views, which has led to a debate between them. David relies on the Capital Market Line (CML), a concept from the Capital Asset Pricing Model (CAPM), to guide his portfolio decisions. He believes that the best way to measure the risk of a portfolio is by looking at its total risk—meaning the overall variability in returns, which is captured by standard deviation. On the other hand, Sarah prefers using the Security Market Line (SML), also from the CAPM framework, and argues that only systematic risk matters in portfolio decisions. She uses beta, a measure of how sensitive a security is to market movements, to assess risk. To help David and Sarah resolve this debate, it's important to understand the purpose and use of both the CML and the SML. Each has a unique way of measuring risk and applies to different kinds of investments. Understanding these differences can help them recognize how both approaches are valid, depending on the context and the type of investor.

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**Q2. Explain how the combination of risky and risk-free assets can be used to construct an optimal portfolio. What role does the CML play in this process?**

**Answer:**

**Introduction:**

Investing money wisely is all about balancing risk and return. Investors want to earn high returns, but they also want to avoid the chance of losing their money. In the real world, no investment is entirely risk-free—except for government-backed securities like Treasury bills. However, most other investments such as stocks, corporate bonds, or mutual funds carry some degree of risk. The key idea in modern portfolio theory is that investors can combine different types of assets—some risky and some risk-free—to build an optimal portfolio that gives them the best possible return for a given level of risk. This process is known as portfolio optimization.

One of the important tools in this process is the Capital Market Line (CML), which helps investors understand the best combination of risky and risk-free assets. The CML shows the risk-return trade-off available to investors and helps them choose the best portfolio based on their own risk preferences. In this explanation, we will look at how combining risky and risk-free assets creates an efficient portfolio and how the CML guides this decision-making.

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**Q3A. The Investor has Rs.30,000/—and decides to invest equally in mutual funds and shares. The expected return from mutual funds is 5% p.a., and from shares is 10% p.a. Calculate the total expected return for one year.**

**Answer:**

**Introduction:**

Investing is a smart way to grow money over time, and individuals often choose different financial instruments based on the expected return and associated risks. Mutual funds and shares are two such popular investment options. In this scenario, an investor has a total of ₹30,000 and decides to split the investment equally between mutual funds and shares. The expected return on mutual funds is 5% per annum, while the return from shares is 10% per annum. To calculate the total expected return in one year, we apply basic principles of investment and percentage calculations to understand the return from each option.

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**Q3B. John is a young investor eager to build his stock portfolio. Mr. Davis, introduces him to the concept of beta. One day, John analyzes two stocks: Stock A has a beta of 1.5, while Stock B has a beta of 0.7. Mr. Davis asks him:**

**“John, if the market rises by 10%, how much would you expect each stock to move? And if the market crashes by 10%, which stock would be riskier? More importantly, based on your risk tolerance, which stock should you choose?”**

**How should John use beta to make his decision? What does beta tell him about the risk and expected return of each stock? Evaluate the significance of beta in the context of CAPM. How does beta influence investment decisions?**

**Answer:**

**Introduction:**

John is a young and enthusiastic investor who wants to grow his wealth by investing in the stock market. He’s just been introduced to the concept of beta by Mr. Davis, an experienced investor. Beta helps measure a stock’s sensitivity to market movements. John is comparing two stocks—Stock A with a beta of 1.5 and Stock B with a beta of 0.7. Mr. Davis challenges John to analyze how these stocks would perform if the market goes up or down by 10%, and asks him to reflect on which stock is riskier and better suited to his personal risk tolerance.

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