27 Lecture - MGT201

Important Subjective

1. **What is the difference between systematic and unsystematic risk?**
   Answer: Systematic risk, also known as market risk, is the risk that affects the entire market or a broad segment of it, such as changes in interest rates, economic conditions, or geopolitical events. Unsystematic risk, on the other hand, is specific to a particular company or industry, such as a management scandal, product recall, or supply chain disruption.

2. **What is the Capital Asset Pricing Model (CAPM) and how does it work?**
   Answer: The CAPM is a financial model that describes the relationship between risk and expected return. It suggests that the expected return on a security is equal to the risk-free rate plus a premium for bearing market risk, which is determined by the security's beta. Beta is a measure of a security's systematic risk relative to the overall market. According to the CAPM, a security's expected return should be proportional to its beta, with higher beta securities having higher expected returns.

3. **What are the assumptions of the CAPM?**
   Answer: The CAPM makes several key assumptions, including that investors are rational and risk-averse, that markets are efficient and all investors have the same information, that there are no transaction costs, taxes or other frictions, and that investors have homogeneous expectations about the future.

4. **What is portfolio theory and how does it relate to risk management?**
   Answer: Portfolio theory is the study of how investors can construct portfolios of assets to optimize their expected return for a given level of risk. The theory emphasizes the importance of diversification, which can reduce unsystematic risk and increase returns through a combination of assets with different correlations. By constructing a portfolio of assets with different levels of risk and return, investors can manage their exposure to risk while potentially earning higher returns.

5. **What is the Sharpe Ratio and how is it used in risk management?**
   Answer: The Sharpe Ratio is a measure of risk-adjusted return that takes into account both the return and the risk of an investment. It is calculated by subtracting the risk-free rate from the portfolio or investment's return, and dividing by the portfolio or investment's standard deviation. The higher the Sharpe Ratio, the better the risk-adjusted return of the investment. The Sharpe Ratio can be used to compare the risk-adjusted returns of different investments or portfolios.

6. **What is beta and how is it used in the CAPM?**
   Answer: Beta is a measure of a security's systematic risk, or the risk that cannot be diversified away. It measures how much a security's returns move relative to the market as a whole. Beta is used in the CAPM to determine the expected return of a security, with higher beta securities expected to have **higher returns.**

7. **What is diversification and how does it reduce risk?**
   Answer: Diversification is the process of investing in a variety of assets that have different risk and return characteristics. By holding a diversified portfolio, an investor can reduce

unsystematic risk, or the risk specific to a particular company or industry, because losses in one area can be offset by gains in another. Diversification can increase the overall return of a portfolio for a given level of risk.

8. **What are the limitations of the CAPM?**
   Answer: The CAPM has several limitations, including that it assumes perfect information and efficient markets, which may not always be the case. It also assumes that investors are rational and risk-averse, which may not always be true. In addition, the CAPM does not take into account other factors that may affect a security's returns, such as liquidity, size, or momentum.

9. **What is the relationship between risk and return?**
   Answer: In general, the higher the risk of an investment, the higher the potential return.