**Capital Market and Portfolio Management**

**Jun 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? (10 Marks)**

**Ans 1.**

**Introduction**

In the realm of portfolio management and capital market theory, the debate between total risk and systematic risk often surfaces, particularly when choosing between the Capital Market Line (CML) and the Security Market Line (SML). David supports the CML, which uses standard deviation to measure total risk, emphasizing the efficient frontier created through a combination of risk-free assets and the market portfolio. On the other hand, Sarah believes in the SML, which uses beta to represent only systematic risk in line with the Capital Asset Pricing Model (CAPM). To help David and Sarah resolve their debate, it is essential to understand the conceptual distinctions between these two models and their implications on risk assessment

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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? (10 Marks)**

**Ans 2.**

**Introduction**

Constructing an optimal portfolio is at the heart of modern portfolio theory, which emphasizes the trade-off between risk and return. Investors often face the challenge of balancing high-return investments with acceptable levels of risk. A widely accepted approach is to combine risky assets, such as stocks, with risk-free assets, such as government securities, to optimize portfolio performance. This combination helps in tailoring investment strategies to suit an investor’s risk tolerance while maximizing expected returns. The Capital Market Line (CML) plays a critical role in this approach, offering the best possible risk-return combinations through efficient portfolios. By understanding how risk-free and risky assets interact within a portfolio,

**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. (5 Marks)**

**Ans 3a.**

**Introduction**

Investors often diversify their capital across various investment avenues to minimize risk and optimize returns. In this case, an individual has ₹30,000 and chooses to invest equally in mutual funds and shares, which provide varying rates of return. Understanding how to calculate the total expected return from such a portfolio is crucial for effective financial planning. By applying basic return formulas and concepts of weighted average returns, we can determine the

**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? (5 Marks)**

**Ans 3b.**

**Introduction**

In the world of stock market investing, understanding risk is as vital as understanding returns. One of the key indicators used to assess a stock’s risk relative to the overall market is beta. For a young investor like John, evaluating beta values can help make informed decisions aligned with personal risk tolerance. By comparing the beta of two stocks—Stock A (1.5) and Stock B (0.7)—John can anticipate how each stock may respond to market movements and tailor his