Modeling Portfolios that Contain Risky Assets
Risk and Reward III: Basic Markowitz Portfolio Theory

C. David Levermore
University of Maryland, College Park

Math 420: Mathematical Modeling
January 30, 2013 version
© 2013 Charles David Levermore
Modeling Portfolios that Contain Risky Assets

Risk and Reward I: Introduction
   II: Markowitz Portfolios
   III: Basic Markowitz Portfolio Theory

Portfolio Models I: Portfolios with Risk-Free Assets
   II: Long Portfolios
   III: Long Portfolios with a Safe Investment

Stochastic Models I: One Risky Asset
   II: Portfolios with Risky Assets

Optimization I: Model-Based Objective Functions
   II: Model-Based Portfolio Management
   III: Conclusion
Risk and Reward III: Basic Markowitz Portfolio Theory

1. How to Build a Portfolio Theory
2. Constrained Minimization Problem
3. Frontier Portfolios
4. General Portfolio with Two Risky Assets
5. Simple Portfolio with Three Risky Assets
6. Efficient-Market Hypothesis
The 1952 Markowitz paper initiated what subsequently became known as *modern portfolio theory* (MPT). Because 1952 was long ago, this name has begun to look silly and some have taken to calling it Markowitz Portfolio Theory (still MPT), to distinguish it from more modern theories. (Markowitz simply called it portfolio theory, and often made fun of the name it acquired.)

**How to Build a Portfolio Theory.** Portfolio theories strive to maximize reward for a given risk — or what is related, minimize risk for a given reward. They do this by quantifying the notions of reward and risk, and identifying a class of idealized portfolios for which an analysis is tractable. Here we present MPT, the first such theory.
Markowitz chose to use the return rate mean $\mu$ as the proxy for the reward of a portfolio, and the volatility $\sigma = \sqrt{\nu}$ as the proxy for its risk. He also chose to analyze the class that we have dubbed Markowitz portfolios. Then for a portfolio of $N$ risky assets characterized by $\mathbf{m}$ and $\mathbf{V}$ the problem of minimizing risk for a given reward becomes the problem of minimizing

$$\sigma = \sqrt{\mathbf{f}^T \mathbf{V} \mathbf{f}}$$

over $\mathbf{f} \in \mathbb{R}^N$ subject to the constraints

$$\mathbf{1}^T \mathbf{f} = 1, \quad \mathbf{m}^T \mathbf{f} = \mu,$$

where $\mu$ is given. Here $\mathbf{1}$ is the $N$-vector that has every entry equal to 1.

Additional constraints can be imposed. For example, if only long positions are to be considered then we must also impose the entrywise constraints $\mathbf{f} \geq 0$, where $\mathbf{0}$ denotes the $N$-vector that has every entry equal to 0.
**Constrained Minimization Problem.** Because $\sigma > 0$, minimizing $\sigma$ is equivalent to minimizing $\sigma^2$. Because $\sigma^2$ is a quadratic function of $f$, it is easier to minimize than $\sigma$. We therefore choose to solve the constrained minimization problem

$$\min_{f \in \mathbb{R}^N} \left\{ \frac{1}{2} f^T V f : 1^T f = 1, \ m^T f = \mu \right\}.$$  

Because there are two equality constraints, we introduce the Lagrange multipliers $\alpha$ and $\beta$, and define

$$\Phi(f, \alpha, \beta) = \frac{1}{2} f^T V f - \alpha (1^T f - 1) - \beta (m^T f - \mu).$$

By setting the partial derivatives of $\Phi(f, \alpha, \beta)$ equal to zero we obtain

$$0 = \nabla_f \Phi(f, \alpha, \beta) = V f - \alpha 1 - \beta m,$$

$$0 = \partial_\alpha \Phi(f, \alpha, \beta) = -1^T f + 1,$$

$$0 = \partial_\beta \Phi(f, \alpha, \beta) = -m^T f + \mu.$$
Because $V$ is positive definite we may solve the first equation for $f$ as

$$f = \alpha V^{-1}1 + \beta V^{-1}m.$$ 

By setting this into the second and third equations we obtain the system

$$\alpha 1^T V^{-1} 1 + \beta 1^T V^{-1} m = 1,$$

$$\alpha m^T V^{-1} 1 + \beta m^T V^{-1} m = \mu.$$ 

If we introduce $a$, $b$, and $c$ by

$$a = 1^T V^{-1} 1, \quad b = 1^T V^{-1} m, \quad c = m^T V^{-1} m,$$

then the above system can be expressed as

$$\begin{pmatrix} a & b \\ b & c \end{pmatrix} \begin{pmatrix} \alpha \\ \beta \end{pmatrix} = \begin{pmatrix} 1 \\ \mu \end{pmatrix}.$$ 

Because $V^{-1}$ is positive definite, the above $2 \times 2$ matrix is positive definite if and only if the vectors $1$ and $m$ are not co-linear ($m \neq \mu 1$ for every $\mu$).
We now assume that 1 and \( m \) are not co-linear, which is usually the case in practice. We can then solve the system for \( \alpha \) and \( \beta \) to obtain

\[
\begin{pmatrix} \alpha \\ \beta \end{pmatrix} = \frac{1}{ac - b^2} \begin{pmatrix} c & -b \\ -b & a \end{pmatrix} \begin{pmatrix} 1 \\ \mu \end{pmatrix} = \frac{1}{ac - b^2} \begin{pmatrix} c - b\mu \\ a\mu - b \end{pmatrix}.
\]

Hence, for each \( \mu \) there is a unique minimizer given by

\[
f(\mu) = \frac{c - b\mu}{ac - b^2} V^{-1} 1 + \frac{a\mu - b}{ac - b^2} V^{-1} m.
\]

The associated minimum value of \( \sigma^2 \) is

\[
\sigma^2 = f(\mu)^T V f(\mu) = \left( \alpha V^{-1} 1 + \beta V^{-1} m \right)^T V \left( \alpha V^{-1} 1 + \beta V^{-1} m \right)
\]

\[
= \begin{pmatrix} \alpha & \beta \end{pmatrix} \begin{pmatrix} a & b \\ b & c \end{pmatrix} \begin{pmatrix} \alpha \\ \beta \end{pmatrix} = \frac{1}{ac - b^2} \begin{pmatrix} 1 & \mu \end{pmatrix} \begin{pmatrix} c & -b \\ -b & a \end{pmatrix} \begin{pmatrix} 1 \\ \mu \end{pmatrix}
\]

\[
= \frac{1}{a} + \frac{a}{ac - b^2} \left( \mu - \frac{b}{a} \right)^2.
\]
Remark. In the case where $1$ and $m$ are co-linear we have $m = \mu 1$ for some $\mu$. If we minimize $\frac{1}{2} f^T V f$ subject to the constraint $1^T f = 1$ then, by Lagrange multipliers, we find that

$$V f = \alpha 1, \quad \text{for some } \alpha \in \mathbb{R}.$$ 

Because $V$ is invertible, for every $\mu$ the unique minimizer is given by

$$f(\mu) = \frac{1}{1^T V^{-1} 1} V^{-1} 1.$$ 

The associated minimum value of $\sigma^2$ is

$$\sigma^2 = f(\mu)^T V f(\mu) = \frac{1}{1^T V^{-1} 1} = \frac{1}{a}.$$ 

Remark. The mathematics behind MPT is fairly elementary. Markowitz had cleverly indentified a class of portfolios which is analytically tractable by elementary methods, and which provides a framework for useful models.
**Frontier Portfolios.** We have seen that for every $\mu$ there exists a unique Markowitz portfolio with mean $\mu$ that minimizes $\sigma^2$. This minimum value is

$$\sigma^2 = \frac{1}{a} + \frac{a}{ac - b^2} \left( \mu - \frac{b}{a} \right)^2.$$  

This is the equation of a hyperbola in the $\sigma \mu$-plane. Because volatility is nonnegative, we only consider the right half-plane $\sigma \geq 0$. The volatility $\sigma$ and mean $\mu$ of any Markowitz portfolio will be a point $(\sigma, \mu)$ in this half-plane that lies either on or to the right of this hyperbola. Every point $(\sigma, \mu)$ on this hyperbola in this half-plane represents a unique Markowitz portfolio. These portfolios are called *frontier portfolios*.

We now replace $a$, $b$, and $c$ with the more meaningful *frontier parameters*

$$\sigma_{mv} = \frac{1}{\sqrt{a}}, \quad \mu_{mv} = \frac{b}{a}, \quad \nu_{as} = \sqrt{\frac{ac - b^2}{a}}.$$
The volatility $\sigma$ for the frontier portfolio with mean $\mu$ is then given by

$$\sigma = \sigma_f(\mu) \equiv \sqrt{\sigma_{mv}^2 + \left(\frac{\mu - \mu_{mv}}{\nu_{as}}\right)^2}.$$  

It is clear that no portfolio has a volatility $\sigma$ that is less than $\sigma_{mv}$. In other words, $\sigma_{mv}$ is the minimum volatility attainable by diversification. Markowitz interpreted $\sigma_{mv}^2$ to be the contribution to the volatility due to the systemic risk of the market, and interpreted $(\mu - \mu_{mv})^2/\nu_{as}^2$ to be the contribution to the volatility due to the specific risk of the portfolio.

The frontier portfolio corresponding to $(\sigma_{mv}, \mu_{mv})$ is called the minimum volatility portfolio. Its associated distribution $f_{mv}$ is given by

$$f_{mv} = f(\mu_{mv}) = f\left(\frac{b}{a}\right) = \frac{1}{a} V^{-1} \mathbf{1} = \sigma_{mv}^2 V^{-1} \mathbf{1}.$$  

This distribution depends only upon $V$, and is therefore known with greater confidence than any distribution that also depends upon $m$. 
The distribution of the frontier portfolio with mean $\mu$ can be expressed as

$$f_f(\mu) \equiv f_{mv} + \frac{\mu - \mu_{mv}}{\nu^2_{as}} V^{-1}(m - \mu_{mv}1).$$

Because $1^T V^{-1}(m - \mu_{mv}1) = b - \mu_{mv}a = 0$, we see that

$$f_{mv}^T V (f_f(\mu) - f_{mv}) = \sigma^2_{mv} \frac{\mu - \mu_{mv}}{\nu^2_{as}} 1^T V^{-1}(m - \mu_{mv}1) = 0.$$

The vectors $f_{mv}$ and $f_f(\mu) - f_{mv}$ are thereby orthogonal with respect to the $V$-inner product, which is given by $(f_1 \mid f_2)_V = f_1^T V f_2$. In the associated $V$-norm, which is given by $\|f\|_V^2 = (f \mid f)_V$, we find that

$$\|f_{mv}\|_V^2 = \sigma^2_{mv}, \quad \|f_f(\mu) - f_{mv}\|_V^2 = \left(\frac{\mu - \mu_{mv}}{\nu_{as}}\right)^2.$$

Hence, $f_f(\mu) = f_{mv} + (f_f(\mu) - f_{mv})$ is the orthogonal decomposition of $f_f(\mu)$ into components that account for the contributions to the volatility due to systemic risk and specific risk respectively.
Remark. Markowitz attributed $\sigma_{mv}$ to systemic risk of the market because he was considering the case when $N$ was large enough that $\sigma_{mv}$ would not be significantly reduced by introducing additional assets into the portfolio. *More generally, one should attribute $\sigma_{mv}$ to those risks that are common to all of the $N$ assets being considered for the portfolio.*

Definition. When two portfolios have the same volatility but different means then the one with the greater mean is said to be more *efficient* because it promises greater reward for the same risk.

Definition. Every frontier portfolio with mean $\mu > \mu_{mv}$ is more efficient than every other portfolio with the same volatility. This segment of the frontier is called the *efficient frontier*.

Definition. Every frontier portfolio with mean $\mu < \mu_{mv}$ is less efficient than every other portfolio with the same volatility. This segment of the frontier is called the *inefficient frontier*. 
The efficient frontier quantifies the relationship between risk and reward that we mentioned in the first lecture. It is the upper branch of the frontier hyperbola in the right-half $\sigma \mu$-plane. It is given as a function of $\sigma$ by

$$
\mu = \mu_{mv} + \nu_{as} \sqrt{\sigma^2 - \sigma_{mv}^2}, \quad \text{for } \sigma > \sigma_{mv}.
$$

This curve is increasing and concave and emerges vertically upward from the point $(\sigma_{mv}, \mu_{mv})$. As $\sigma \to \infty$ it becomes asymptotic to the line

$$
\mu = \mu_{mv} + \nu_{as} \sigma.
$$

The inefficient frontier is the lower branch of the frontier hyperbola in the right-half $\sigma \mu$-plane. It is given as a function of $\sigma$ by

$$
\mu = \mu_{mv} - \nu_{as} \sqrt{\sigma^2 - \sigma_{mv}^2}, \quad \text{for } \sigma > \sigma_{mv}.
$$

This curve is decreasing and convex and emerges vertically downward from the point $(\sigma_{mv}, \mu_{mv})$. As $\sigma \to \infty$ it becomes asymptotic to the line

$$
\mu = \mu_{mv} - \nu_{as} \sigma.
$$
General Portfolio with Two Risky Assets. Consider a portfolio of two risky assets with mean vector $\mathbf{m}$ and covariance matrix $\mathbf{V}$ given by

$$\mathbf{m} = \begin{pmatrix} m_1 \\ m_2 \end{pmatrix}, \quad \mathbf{V} = \begin{pmatrix} v_{11} & v_{12} \\ v_{12} & v_{22} \end{pmatrix}.$$

The constraints $\mathbf{1}^\top \mathbf{f} = 1$ and $\mathbf{m}^\top \mathbf{f} = \mu$ uniquely determine $\mathbf{f}$ to be

$$\mathbf{f}(\mu) = \begin{pmatrix} f_1(\mu) \\ f_2(\mu) \end{pmatrix} = \frac{1}{m_2 - m_1} \begin{pmatrix} m_2 - \mu \\ \mu - m_1 \end{pmatrix}.$$

Because there is exactly one portfolio for each $\mu$, every portfolio must be a frontier portfolio. Therefore there is no optimization problem to solve and $\mathbf{f}_f(\mu) = \mathbf{f}(\mu)$. These portfolios trace out the hyperbola

$$\sigma^2 = \mathbf{f}(\mu)^\top \mathbf{V} \mathbf{f}(\mu) = \frac{v_{11}(m_2 - \mu)^2 + 2v_{12}(m_2 - \mu)(\mu - m_1) + v_{22}(\mu - m_1)^2}{(m_2 - m_1)^2}.$$
The frontier parameters $\mu_{mv}$, $\sigma_{mv}$, and $\nu_{as}$ are given by

$$\mu_{mv} = \frac{(v_{22} - v_{12})m_1 + (v_{11} - v_{12})m_2}{v_{11} + v_{22} - 2v_{12}},$$

$$\sigma_{mv}^2 = \frac{v_{11}v_{22} - v_{12}^2}{v_{11} + v_{22} - 2v_{12}}, \quad \nu_{as}^2 = \frac{(m_2 - m_1)^2}{v_{11} + v_{22} - 2v_{12}}.$$

The minimum volatility portfolio is

$$f_{mv} = \sigma_{mv}^2 V^{-1}1 = \frac{\sigma_{mv}^2}{v_{11}v_{22} - v_{12}^2} \begin{pmatrix} v_{22} & -v_{12} \\ -v_{12} & v_{11} \end{pmatrix} \begin{pmatrix} 1 \\ 1 \end{pmatrix}$$

$$= \frac{1}{v_{11} + v_{22} - 2v_{12}} \begin{pmatrix} v_{22} - v_{12} \\ v_{11} - v_{12} \end{pmatrix}.$$

**Remark.** Each $(\sigma_i, m_i)$ lies on the frontier of every two-asset portfolio. Typically each $(\sigma_i, m_i)$ lies strictly to the right of the frontier of a portfolio that contains more than two risky assets.
Remark. The foregoing two-asset portfolio example also illustrates the following general property of frontier portfolios that contain two or more risky assets. Let $\mu_1$ and $\mu_2$ be any two return rate means with $\mu_1 < \mu_2$. The distributions of the associated frontier portfolios are then $f_1 = f_f(\mu_1)$ and $f_2 = f_f(\mu_2)$. Because $f_f(\mu)$ depends linearly on $\mu$ we see that

$$f_f(\mu) = \frac{\mu_2 - \mu}{\mu_2 - \mu_1} f_1 + \frac{\mu - \mu_1}{\mu_2 - \mu_1} f_2.$$  

This formula can be interpreted as stating that every frontier portfolio can be realized by holding positions in just two funds that have the portfolio distributions $f_1$ and $f_2$. When $\mu \in (\mu_1, \mu_2)$ both funds are held long. When $\mu > \mu_2$ the first fund is held short while the second is held long. When $\mu < \mu_1$ the second fund is held short while the first is held long. This observation is often called the Two Mutual Fund Theorem, which is a label that elevates it to a higher status than it deserves. We will call it simply the Two Fund Property.
**Simple Portfolio with Three Risky Assets.** Consider a portfolio of three risky assets with mean vector $\mathbf{m}$ and covariance matrix $\mathbf{V}$ given by

$$
\mathbf{m} = \begin{pmatrix} m_1 \\ m_2 \\ m_3 \end{pmatrix} = \begin{pmatrix} m - d \\ m \\ m + d \end{pmatrix}, \quad \mathbf{V} = s^2 \begin{pmatrix} 1 & r & r \\ r & 1 & r \\ r & r & 1 \end{pmatrix}.
$$

Here $m \in \mathbb{R}$, $d, s \in \mathbb{R}_+$, and $r \in (-\frac{1}{2}, 1)$. The last condition is equivalent to the condition that $\mathbf{V}$ is positive definite given $s > 0$. This portfolio has the unrealistic properties that (1) every asset has the same volatility $s$, (2) every pair of distinct assets has the same correlation $r$, and (3) the return rate means are uniformly spaced with difference $d = m_3 - m_2 = m_2 - m_1$. These simplifications will make it easier to follow the ensuing calculations than it would be for a more general three-asset portfolio. We will return to this simple portfolio in subsequent examples.
It is helpful to express $m$ and $V$ in terms of $1$ and $n = (-1 \ 0 \ 1)^T$ as

$$m = m \mathbf{1} + d \mathbf{n}, \quad V = s^2(1 - r) \left( \mathbf{I} + \frac{r}{1 - r} \mathbf{1} \mathbf{1}^T \right).$$

Notice that $1^T \mathbf{1} = 3$, $1^T \mathbf{n} = 0$, and $\mathbf{n}^T \mathbf{n} = 2$. It can be checked that

$$V^{-1} = \frac{1}{s^2(1 - r)} \left( \mathbf{I} - \frac{r}{1 + 2r} \mathbf{1} \mathbf{1}^T \right), \quad V^{-1} \mathbf{1} = \frac{1}{s^2(1 + 2r)} \mathbf{1},$$

$$V^{-1} \mathbf{n} = \frac{1}{s^2(1 - r)} \mathbf{n}, \quad V^{-1} \mathbf{m} = \frac{m}{s^2(1 + 2r)} \mathbf{1} + \frac{d}{s^2(1 - r)} \mathbf{n}.$$ 

The parameters $a$, $b$, and $c$ are therefore given by

$$a = 1^T V^{-1} \mathbf{1} = \frac{3}{s^2(1 + 2r)}, \quad b = 1^T V^{-1} \mathbf{m} = \frac{3m}{s^2(1 + 2r)},$$

$$c = \mathbf{m}^T V^{-1} \mathbf{m} = \frac{3m^2}{s^2(1 + 2r)} + \frac{2d^2}{s^2(1 - r)}.$$
The frontier parameters are then
\[ \sigma_{mv} = \sqrt{\frac{1}{a}} = s \sqrt{\frac{1 + 2r}{3}}, \quad \mu_{mv} = \frac{b}{a} = m, \]
\[ \nu_{as} = \sqrt{c - \frac{b^2}{a}} = \frac{d}{s} \sqrt{\frac{2}{1 - r}}, \]
whereby the frontier is given by
\[ \sigma = \sigma_f(\mu) = s \sqrt{\frac{1 + 2r}{3} + \frac{1 - r}{2} \left( \frac{\mu - m}{d} \right)^2} \quad \text{for} \quad \mu \in (-\infty, \infty). \]

Notice that each \((\sigma_i, m_i)\) lies strictly to the right of the frontier because
\[ \sigma_{mv} = \sigma_f(m) = s \sqrt{\frac{1 + 2r}{3}} < \sigma_f(m \pm d) = s \sqrt{\frac{5 + r}{6}} < s. \]

Notice that as \(r\) decreases the frontier moves to the left for \(|\mu - m| < \frac{2}{3} \sqrt{3}d\) and to the right for \(|\mu - m| > \frac{2}{3} \sqrt{3}d\).
The minimum volatility portfolio has distribution
\[ f_{mv} = \sigma_{mv}^2 V^{-1}1 = \frac{1}{3} 1, \]
while the distribution of the frontier portfolio with return rate mean \( \mu \) is
\[ f_f(\mu) = f_{mv} + \frac{\mu - \mu_{mv}}{\nu a s} V^{-1}(m - \mu_{mv}1) = \left( \begin{array}{c} \frac{1}{3} - \frac{\mu - m}{2d} \\ \frac{1}{3} + \frac{\mu - m}{2d} \end{array} \right). \]

Notice that the frontier portfolio will hold long positions in all three assets when \( \mu \in (m - \frac{2}{3}d, m + \frac{2}{3}d) \). It will hold a short position in the first asset when \( \mu > m + \frac{2}{3}d \), and a short position in the third asset when \( \mu < m - \frac{2}{3}d \). In particular, in order to create a portfolio with return rate mean \( \mu \) greater than that of any asset contained within it you must short sell the asset with the lowest return rate mean and invest the proceeds into the asset with the highest return rate mean. The fact that \( f_f(\mu) \) is independent of \( V \) is a consequence of the simple forms of both \( V \) and \( m \). This is also why the fraction of the investment in the second asset is a constant.
Remark. The frontier portfolios in the above examples are independent of all the parameters in $V$. While this is not generally true, it is generally true that they are independent of the overall market volatility. In particular, they are independent of the factor $D(D - 1)$ that was chosen to normalize $V$. Said another way, the frontier portfolios depend only upon the correlations $c_{ij}$, the volatility ratios $\sigma_i/\sigma_j$, and the means $m_i$. Moreover, the minimum volatility portfolio $f_{mv}$ depends only upon the correlations and the volatility ratios. Because markets can exhibit periods of markedly different volatility, it is natural to ask when correlations and volatility ratios might be relatively stable across such periods.

Remark. The efficient frontier quantifies the relationship between risk and reward that we mentioned earlier. A portfolio management theory typically assumes that investors prefer efficient frontier portfolios and will therefore select an efficient frontier portfolio that is optimal given some measure of the risk aversion of an investor. Our goal is to develop such theories.
Exercise. Consider the following groups of assets:

(a) Google, Microsoft, Exxon-Mobil, UPS, GE, and Ford stock in 2009;
(b) Google, Microsoft, Exxon-Mobil, UPS, GE, and Ford stock in 2007;
(c) S&P 500 and Russell 1000 and 2000 index funds in 2009;

On a single graph plot the points \((\sigma_i, m_i)\) for every asset in groups (a) and (c) along with the frontiers for group (a), for group (c), and for groups (a) and (c) combined. Do the same thing for groups (b) and (d) on a second graph. (Use daily data.) Comment on any relationships you see between the objects plotted on each graph.

Exercise. Compute the minimum volatility portfolio \(f_{mv}\) for group (a), for group (c), and for groups (a) and (c) combined. Do the same thing for group (b), for group (d), and for groups (b) and (d) combined. Compare these results for the analogous groupings in 2007 and 2009.
The *efficient-market hypothesis* (EMH) was framed by Eugene Fama in the early 1960’s in his University of Chicago doctoral dissertation, which was published in 1965. It has several versions, the most basic is the following.

*Given the information available when an investment is made, no investor will consistently beat market returns on a risk-adjusted basis over long periods except by chance.*

This version of the EMH is called the *weak* EMH. The *semi-strong* and the *strong* versions of the EMH make bolder claims that markets reflect information instantly, even information that is not publicly available in the case of the strong EMH. While it is true that some investors react quickly, most investors do not act instantly to every piece of news. Consequently, there is little evidence supporting these stronger versions of the EMH.
The EMH is an assertion about markets, not about investors. If the weak EMH is true then the only way for an actively-managed fund to beat the market is by chance. Of course, there is some debate regarding the truth of the weak EMH. It can be recast in the language of MPT as follows.

*Markets for large classes of assets will lie on the efficient frontier.*

Therefore you can test the weak EMH with MPT. If we understand “market” to mean a capitalization weighted collection of assets (i.e. an index fund) then the EMH can be tested by checking whether index funds lie on or near the efficient frontier. You will see that this is often the case, but not always.

**Remark.** *It is a common misconception that MPT assumes the weak EMH. It does not, which is why the EMH can be checked with MPT!*
Remark. It is often asserted that the EMH holds in rational markets. Such a market is one for which information regarding its assets is freely available to all investors. *This does not mean that investors will act rationally based on this information!* Nor does it mean that markets price assets correctly. Even rational markets are subject to the greed and fear of its investors. That is why we have bubbles and crashes. Rational markets can behave irrationally because information is not knowledge!

Remark. It could be asserted that the EMH is likely to hold in free markets. Such markets have many agents, are rational and subject to regulatory and legal oversight. *These are all elements in Adam Smith’s notion of free market, which refers to the freedom of its agents to act, not to the freedom from any government role.* Indeed, his radical idea was that government should nurture free markets by playing the role of empowering individual agents. He had to write his book because free markets do not arise spontaneously, even though his “invisible hand” insures that markets do.
**Remark.** If the index funds did always lie on the efficient frontier then by the Two Fund Property we would be able to take any position on the efficient frontier simply by investing in index funds. This idea underpins the strategy advanced in “A Random Walk Down Wall Street” by Burton G. Malkiel.

**Exercise.** Select at least one index fund for the following asset classes:

1. stocks of large U.S. companies,
2. stocks of small U.S. companies,
3. stocks of non-U.S. companies,
4. U.S. corporate bonds,
5. U.S. government bonds,
6. non-U.S. bonds.

Compute their efficient frontier for each of the years 2007 through 2012. What is the relationship of each of these market indices to the efficient frontier for each of these years?