CONCEPT: DIVERSIFICATION, FIRM-SPECIFIC RISK, AND MARKET RISK

● ***Risk*** – uncertainty regarding the amount of future gains or losses

□ ***Diversification*** – reducing risk by replacing a single large risk, with smaller, unrelated risks

> How to diversify? Hold a large number of different investments, rather than just one.

Firm-specific Risk	**Market Risk**
Risk that only affects __________________	Risk that affects __________________
Examples:	Examples:
Firm-specific risk _____________ be diversified	Market risk _____________ be diversified

□ A riskier investment must pay a _____________ rate of return

> ***Risk-free rate of return*** – the return on an investment that has ________ risk

- Example: ____________________________

$$Rate\ of\ Return = \frac{Income}{Price}$$

● How can we be sure of the price of an asset on the market?

□ ***Efficient Market Hypothesis*** – current asset prices reflect all publicly available ______________ about its value

> Under this hypothesis, markets are said to exhibit ***informational efficiency***

> Stock prices change when new information becomes available

- New information must be unpredictable, otherwise it wouldn't be new

- ***Random Walk*** – the path of a variable whose changes are impossible to predict

□ Are people completely rational in the market?

> Example: Dot-com bubble of the late 1990s, real estate bubble of 2008

> People ***speculate*** on assets that appear to be increasing in value

- FOMO