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Foundations of Portfolio Theory

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WHEN I STUDIED MICROECONOMICS forty years ago, I was first taught how optimizing firms and consumers would behave, and then taught the nature of the economic equilibrium which would result from such behavior. Let me refer to this as part one and part two of my microeconomics course. My work on portfolio theory considers how an optimizing investor would behave, whereas the work by Sharpe and Lintner on the Capital Asset Pricing Model (CAPM for short) is concerned with economic equilibrium assuming all investors optimize in the particular manner I proposed. Thus my work on the one hand, and that of Sharpe and Lintner on the other, provide part one and part two of a microeconomics of capital markets.

Professor Sharpe will discuss CAPM, part two of the course. I will confine my remarks to part one, portfolio theory. There are three major ways in which portfolio theory differs from the theory of the firm and the theory of the consumer which I was taught. First, it is concerned with investors rather than manufacturing firms or consumers. Second, it is concerned with economic agents who act under uncertainty. Third, it is a theory which can be used to direct practice, at least by large (usually institutional) investors with sufficient computer and database resources. The fact that it deals with investors rather than producers or consumers needs no further comment. Let me expand on the second and third differences.

In my microeconomics course, the theory of the producer assumed that the competitive firm knows the price at which it will sell the goods it produces. In the real world there is a delay between the decision to produce, the time of production and the time of sale. The price of the product at the time of sale may differ from that which was expected when the production decision was made. This uncertainty of eventual sales price is important in actual production planning but, quite reasonably, was ignored in classical economic models. It was judged not essential to the problem at hand.

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