Question 2

a. The Capital Asset Pricing Model (CAPM) is a widely used concept in finance. The Model is expressed graphically by the Security Market Line (SML). Within the context of investment, explain how CAPM can be useful to investors.

b. Explain Efficient Market Hypothesis (EMH) and the different types of market efficiency. Do stock market anomalies contradict the concept of market efficiency? Explain.

c. The distributions of rates of return for Security AA and Security BB are given below:

State of Economy State	Probability of Occurring	Security AA	Security BB
Boom	0.2	30 %	-10 %
Normal	0.6	10	5
Recession	0.2	-5	50

Based on the above information can we conclude that any rational risk-averse investor will add Security AA to a well-diversified portfolio over Security BB. Why? Or why not?