CONTENTS

THE INVESTMENT BACKGROUND 2

Chapter 1 The Investment Setting 4

What Is an Investment? 4

Measures of Return and Risk 6

Measures of Historical Rates of Return 7 Computing Mean Historical Returns 8 Calculatine Expected Rates of Return 11

Measuring the Risk of Expected Rates of Return 14 Risk Measures for Historical Returns 16 Determinants of Required Rates of Return 17

The Real Risk-Free Rate 18 Factors Influencing the Nominal Risk-Free Rate 18

Risk Premium 21 Risk Premium and Portfolio Theory 24 Fundamental Risk Versus Systematic Risk 24

Summary of Required Rate of Return 25 Relationship Between Risk and Return 25 Movements Along the SML 26

Changes in the Slope of the SML 27 Changes in Capital Market Conditions or Expected Inflation 29 Summary 30

Outline of the Book 31

Appendix 1A Computation of Variance and Standard Deviation 36

Selecting Investments in a Global Market 40 The Case for Global Investments 41 Relative Size of U.S. Financial Markets 42 Rates of Return on U.S. and Foreign Securities 43 Global Bond Market Returns 44 Global Equity Market Returns 44

Individual Country Equity Risk and Return 45

Risk of Combined Country Investments 45 Global Investment Choices 52 Fixed-Income Investments 53 Equity Instruments 57

Special Equity Instruments: Options 59 Futures Contracts 60

Investment Companies 61 Real Estate 62 Low-Liquidity Investments 63

Historical Risk/Returns on Alternative Stocks, Bonds, and T-Bills 65

World Portfolio Performance 67 Art and Antiques 69 Summary 71

Appendix 2A

Covariance and Correlation 78

Chapter 3

Organization and Functioning of Securities Markets 81

What Is a Market? 82 Characteristics of a Good Market 82

Organization of the Securities Market 84 Primary Capital Markets 84 Government Rond Issues 84

Municipal Rond Issues 84 Cornorate Issues 85 Private Placements and Rule 144A 87

Secondary Financial Markets 88 Why Secondary Markets Are Important 88 Secondary Bond Markets 88

Financial Futures 89 Equity Markets 89 Detailed Analysis of Exchange Markets 103

Exchange Membership 103 Types of Orders 103

Exchange Market Makers 108 Changes in the Securities Markets 112 Evidence and Effect of Institutionalization 112 Negotiated Commission Rates 113 The Impact of Block Trades 115 Institutions and Stock Price Volatility 116 National Market System (NMS) 116 New Trading Systems 119

Global Market Changes 120

Future Developments 122

Summary 124

Appendix 3A Description of Characteristics of Developed and Developing Markets Around the World 128

Chapter 4

Security-Market Indicator Series 131 Uses of Security-Market Indexes 132

Differentiating Factors in Constructing Market Indexes 133

The Sample 133 Weighting of Sample Members 133

Computational Procedure 133 Stock-Market Indicator Series 134 Price-Weighted Series 134

Value-Weighted Series 136 Unweighted Price Indicator Series 147 Global Equity Indexes 145

Bond-Market Indicator Series 150 Total Pate of Return Series 150 Global Bond Indexes 151

Composite Stock-Bond Indexes 152 Comparison of Indexes Over Time 153 Correlations Among Daily Equity Price Changes 153 Correlations Among Monthly Bond Indexes 155 Annual Stock Price Changes 155

Annual Bond Rates of Return 155 Summary 158

Appendix 4A Foreign Stock Market Indexes 162

Chapter 5 Sources of Information on Global Investments 163

Aggregate Economic Analysis 164 U.S. Government Sources 164 Bank Publications 165

Non-U.S. Economic Data 166 Aggregate Security-Market Analysis 168 Government Publications 168 Commercial Publications 168 Brokerage Firm Reports 172 Industry Analysis 174

Industry Publications 174 Industry Magazines 174 Trade Associations 175

Individual Stock and Bond Analysis 175 Company-Generated Information 175 Commercial Publications 177 Brokerage Firm Reports 183

Investment Magazines 183 Theoretical and Empirical Analysis 186 Academic Journals 186 Computerized Data Sources 187 Data Banks 187

On-Line Data Bases 188 Summary 189 Sources of Investment Information 190 PART II

DEVELOPMENTS IN INVESTMENT THEORY 192

Chapter 6

Efficient Capital Markets 194 Why Should Capital Markets Be Efficient? 195

Alternative Efficient Market Hypotheses 196 Expected Return or Fair Game Model 196 Weak-Form Efficient Market Hypothesis 198 Semistrong-Form Efficient Market Hypothesis 198

Strong-Form Efficient Market Hypothesis 198 Tests and Results of Alternative Efficient Market Hypotheses 198

Weak-Form Hypothesis: Tests and Results 199 Semistrong-Form Hypothesis: Tests and Results 202 Strong-Form Hypothesis: Tests and Results 221

Implications of Efficient Capital Markets 228 Efficient Markets and Technical Analysis 228 Efficient Markets and Fundamental Analysis 229 Efficient Markets and Portfolio Management 231 Efficiency in European Equity Markets 233

Summary 234 Chapter 7

An Introduction to Portfolio Management 240

Some Background Assumptions 241 Risk Aversion 241

Definition of Risk 242 Markowitz Portfolio Theory 242 Alternative Measures of Risk 243 Expected Rates of Return 243 Variance (Standard Deviation) of Returns for an Individual

Investment 244 Variance (Standard Deviation) of Returns for a Portfolio 245 Standard Deviation of a Portfolio 250

The Efficient Frontier 258 The Efficient Frontier and Investor Utility 260

Summary 261

Appendix 7A Proof That Minimum Portfolio Variance Occurs with Equal Weights When Securities Have Equal Variance 265

Appendix 7B Derivation of Weights That Will Give Zero Variance When Correlation Equals - 1.00 266

An Introduction to Asset Pricing Models 267

Capital Market Theory 268 Background for Capital Market Theory 269 Risk-Free Asset 270 The Market Portfolio 274 The Capital Asset Pricing Model: Expected Return and

Risk 278 Arbitrage Pricing Theory (APT) 288 Empirical Tests of the APT 291

Summary 291

Chapter 9 An Introduction to Derivative Markets and

Securities 296 Options 297

Option Terminology 298 Forward and Futures Contracts 299 The Pricing of Options 300 Basic Concepts of Value 300

Lower Bounds on Option Prices 302 Option Pricing in a Two-State World 303

The Pricing of Forward and Futures Contracts 306 Basic Concepts of Value 307 The Relationship Between Current and Expected Future

Spot Prices 309 The Relationship Between Spot and Futures Prices 310 Parity Relations Among Puts, Calls, and Futures 311 The Role of Derivative Instruments in Investment

Analysis and Portfolio Management 312 The Efficiency of Derivative Markets 313 Do Derivatives Lead the Snot Market? 313

Are Derivatives Correctly Priced? 314 Summary 315

VALUATION PRINCIPLES AND PRACTICES 320

Chapter 10

Analysis of Financial Statements 322

Major Financial Statements 323 Balance Sheet 323 Income Statement 323 Statement of Cash Flow 323 Purpose of Financial Statement Analysis 324

Analysis of Financial Ratios 325 Why Ratios of Financial Data? 325 Importance of Relative Financial Ratios 325 Computation of Financial Ratios 328

Ratio Categories 328 Evaluating Internal Liquidity 328 Internal Liquidity Ratios 328 Evaluating Operating Performance 331

Operating Efficiency Ratios 331 Operating Profitability Ratios 334 Risk Analysis 342 Business Risk 342

Financial Risk 345 Analysis of Growth Potential 353

Importance of Growth Analysis 353 Determinants of Growth 353 External Market Liquidity 355

Market Liquidity Defined 355 Determinants of Market Liquidity 355

Comparative Analysis of Ratios 356 Internal Liquidity 358

Operating Performance 358 Financial Risk 358 Growth Analysis 358

Analysis of Non-U.S. Financial Statements 359 Accounting Statement Format Differences 359 Differences in Accounting Principles 361

International Ratio Analysis 361 Uses of Financial Ratios 362 Stock Valuation Models 362 Financial Ratios and Systematic Risk 362 Financial Ratios and Bond Ratings 366 Financial Ratios and Insolvency (Bankruptcy) 367 Limitations of Financial Ratios 367

Summary 368 Chapter 11

Introduction to Security Valuation 375 An Overview of the Valuation Process 377 Why a Three-Step Valuation Process? 377 General Economic Influences 377

Industry Influences 378 Company Analysis 379 Does the Three-Step Process Work? 379

Theory of Valuation 380 Stream of Expected Returns 381 Required Rate of Return 381 Investment Decision Process: A Comparison of Estimated

Values and Market Prices 381 Valuation of Alternative Investments 382 Valuation of Bonds 387

Valuation of Preferred Stock 383 Valuation of Common Stocks 384 Valuation with Temporary Supernormal Growth 391

Earnings Multiplier Model 392 Estimating the Inputs: The Required Rate of Return and the Expected Growth Rate of

Dividends 395 Required Rate of Return (k) 395 Estimating the Required Return for Foreign Securities 398 Expected Growth Rate of Dividends 401 Estimating Dividend Growth for Foreign Stocks 403

Summary 404 Appendix 11A

Derivation of Constant Growth Dividend Discount Model 407

Chapter 12

The Analysis of Alternative Economies and the Security Markets: The Global Asset Allocation Decision 409

Economic Activity and Security Markets 411 Cyclical Indicator Approach to Forecasting the

Economy 412
Cyclical Indicator Categories 413
Analytical Measures of Performance 415
Limitations of the Cyclical Indicator Approach 417

Leading Indicators and Stock Prices 417 Other Leading Indicator Series 417 Monetary Variables, the Economy, and Stock

Monetary Variables, the Economy, and Stock Prices 420 Money Supply and the Economy 420

Money Supply and Stock Prices 421
Other Economic Variables and Stock Prices 423
Inflation, Interest Rates, and Security Prices 427
Analysis of World Security Markets 427

Analysis of World Security Markets 427 Inflation and Exchange Rates 428 Correlations Among Returns 430 Individual Country Stock Price Changes 430 Individual Country Analysis 432

World Asset Allocation 432 Summary 435

PART IV
ANALYSIS AND MANAGEMENT OF

BONDS 440

Chapter 13 Bond Fundamentals 442

Basic Features of a Bond 443 Bond Characteristics 443 Rates of Return on Bonds 446

The Global Bond-Market Structure 446
Participating Issuers 447
Participating Investors 450
Bond Ratings 450

Alternative Bond Issues 451 Domestic Government Bonds 453 Government Agency Issues 456 Municipal Bonds 459 Corporate Bonds 461

International Bonds 471
Obtaining Information on Bonds 473
Required Information 473
Sources of Bond Quotes 473

Interpreting Bond Quotes 474 Summary 478 Chapter 14

The Valuation of Bonds 483

The Fundamentals of Bond Valuation 484
The Present Value Model 484
The Yield Model 485

Computing Bond Yields 486 Nominal Yield 487 Current Yield 487 Promised Yield to Maturity 487

Promised Yield to Maturity 4
Promised Yield to Call 491
Realized Yield 493

Realized Yield 493 Calculating Future Bond Prices 494 Realized Yield with Differential Reinvestment Rates 496

Price and Yield Determination on Noninterest Rates 498
Yield Adjustments for Tax-Exempt Bonds 498
Bond Yield Books 499

What Determines Interest Rates? 499
Forecasting Interest Rates 501
Fundamental Determinants of Interest Rates 501
Term Structure of Interest Rates 505

term Structure of Interest Rates 505 Yield Spreads 512 What Determines the Price Volatility for Bonds? 513 Some Trading Strutegies 516 The Duration Measure 516

Duration Measure 516
Duration and Bond Price Volatility 520
Bond Convexity 521

Duration and Convexity for Callable Bonds 527 Summary 529

napter 15

Bond Portfolio Management Strategies 534

Alternative Bond Portfolio Strategies 535
Passive Bond Portfolio Strategies 535
Active Management Strategies 537
A Global Fixed-Income Investment Strategy 549

Matched-Funding Techniques 551 Contingent Procedures 565 Implications of Capital Market Theory and the EMH on Bond Portfolio Management 571

Bonds and Total Portfolio Theory 571

Bonds and Capital Market Theory 572

Bond Price Behavior in a CAPM Framework 573

Bond-Market Efficiency 577 Summary 578

PART V

ANALYSIS OF COMMON STOCKS 586

Chapter 16 Stock-Market Analysis 588

Applying the Valuation Model to the Market 589 Two-Part Valuation Procedure 590 Importance of Both Components of Value 591

Estimating Expected Earnings per Share 593 Estimating Gross National Product 594 Estimating Sales per Share for a Market Series 594 Alternative Estimates of Corporate Net Profits 595 Estimating Aggregate Operating Profit Margin 598 Estimating Depreciation Expense 601 Estimating Interest Expense 602 Estimating the Tax Rate 602

Calculating Earnings per Share: An Example 603 Estimating the Earnings Multiplier for a Stock-Market

Series 605 Determinants of the Earnings Multiplier 605 Estimating an Earnings Multiplier: An Example 612 Calculating an Estimate of the Value for the Market

Series 615 Calculating the Expected Rate of Return on Common Stocks 615

Analysis of World Markets 617 Individual Country Analysis 619 Summary 619

Chapter 17

Industry Analysis 626

Why Do Industry Analysis? 627 Cross-Sectional Industry Performance 628 Industry Performance Over Time 628 Performance of the Companies Within an Industry 628 Differences in Industry Risk 629 Summary of Research on Industry Analysis 629

Estimating Industry Rates of Return 630 Estimating Earnings per Share 630 Forecasting Sales per Share 630 Industry Profit Margin Forecast 636 An Example of an Industry Earnings Estimate 640 Estimating an Industry Earnings Multiplier 642 Macroanalysis of an Industry Multiplier 642

Microanalysis of an Industry Multiplier 642 Why the Difference? 650 Estimating the Future 650 Competition and Expected Industry Returns 651 Basic Competitive Forces 652

Global Industry Analysis 653 The European Chemical Industry 654 Summary 656

Appendix 17A Preparing an Industry Analysis 658

Company Analysis and Stock Selection 661

Analysis of Companies Versus the Selection of Stock 662

Growth Companies and Growth Stocks 662 Other Company-Stock Comparisons 663 Estimating the Value of a Company 664 Estimating Company Earnings per Share 665 Company Sales Forecast 665

Estimating the Company Profit Margin 668 Estimating Company Earnings Multipliers 673 Macroanalysis of the Earnings Multiplier 673 Microanalysis of the Earnings Multiplier 674 Making the Investment Decision 680 Additional Measures of Relative Value 682

Price/Book Value (P/BV) Ratio 682 Price/Cash Flow (P/CF) Ratio 683 Identifying and Selecting Competitive

Strategies 686 Low-Cost Strategy 687 Differentiation Strategy 687

Focusing a Strategy 687 Global Company Analysis 688 Earnings per Share Analysis 688 Profitability and Financial Strength 688 Common Stock Statistics 689 Share Price Performance 689 Individual Company Analysis 692 Analysis of Growth Companies 692

Growth Company Defined 693 Actual Returns Above Expected Returns 693 Growth Companies and Growth Stocks 694 Growth Companies and the Dividend Discount Model 694 Alternative Growth Models 695

No-Growth Firm 695 Long-Run Growth Models 695 The Real World 699 Growth Duration 699 A Flexible Growth Stock Valuation Model 703 An Example 706 Summary 708

Chapter 19

Technical Analysis 714

Underlying Assumptions of Technical Analysis

Challenges to Technical Analysis 717 Challenges to Technical Analysis Assumptions 717 Challenges to Technical Trading Rules 717 Advantages of Technical Analysis 718 Technical Trading Rules and Indicators 719 Contrary-Opinion Rules 720

Follow the Smart Money 725 Other Market Environment Indicators 728 Stock Price and Volume Techniques 733 Technical Analysis of Foreign Markets 741 Technical Analysis of Bond Markets 742

Summary 744

PART VI			
ANALYSIS	OF	ALTERN	ATIV

INVESTMENTS 750 Chapter 20

Stock Options 752 Recent History of Options Trading 753 Ontions Markets 754 Volume of Trading 755 A Sample Quotation 758 Ontion Trading Strategies 759

Buying Call Options 761 Selling Call Options 762 Buying Put Options 764 Selling Put Options 767

Spreads 767 Valuation 770 The Black-Scholes Option Pricing Model 771

Implementing the Model 772 American Option Pricing 775

Investor Experience with Options 778 Summary 778

Warrants and Convertible Securities 783

Simple Corporate Securities 784 Stock as an Option 784 Bonds as an Option 785 Warrants 788

Example of Warrants 789 Valuation of Warrants 791 Other Types of Warrants 793 Convertible Securities 794 Characteristics of Convertible Bonds 795 Advantages to Issuing Firms 795 Advantages to Investors 795

Valuation of Convertible Bonds 796 Forcing Conversion 799 Sources of Information on Convertibles 800

Convertible Preferred Stock 800 Indexed and Other Hybrid Securities 803 Summary 805

Appendix 21A

Convertible Glossary 809

Chapter 22 Futures 811

Forward Versus Futures Contracts 812 A Brief History of Futures Trading 813 Futures Markets 813

Similarities and Differences in Stock and Futures Trading

Practices 814

Futures Exchanges and Contracts 816 Volume of Trading 817 Futures Quotations 818

Different Types of Futures Contracts 821 Commodity Futures 821 Interest Rate Futures 822

Stock Index Futures 824 Hedging 824

Determining the Hedge Ratio 826 The Portfolio Approach to Determining the Hedge Ratio

Price-Sensitivity Approach to Hedging with Interest Rate

Some Hedging Examples 830 Hedging the Delivery of a Crop 831 Hedging a Long Position in Treasury Bonds 832

Hedging a Long Position in a Stock Portfolio 833 Speculation 834 Arbitrage 835 Treasury Bill Arbitrage 836

Stock Index Arbitrage 837 Economic Functions of Futures Markets 839 The Returns to Futures Trading 839 Summary 840

Advanced Topics on Options and Futures 845

Options on Futures 846 A Sample Quotation 846 Some Fundamentals of Pricing Options on Futures 847 A Model for Pricing Options on Futures 848

Foreign Currency Derivatives 850 Sample Quotations 850 Pricing Currency Derivatives 853

Hedging Foreign Currency Risk 855 Interest Rate Agreements 859 Interest Rate Options 859 Interest Rate Floors, Caps, and Collars 862

Interest Rate Swaps 867 Portfolio Insurance 870 Program Trading 871 Program Trading and the 1987 Crash 873

Chapter 24

Summary 874

Investment Companies 878 What Is an Investment Company? 879 Management of Investment Companies 880

Closed-End Versus Open-End Investment Companies 880 Closed-End Investment Companies 880 Open-End Investment Companies 884 Fund Management Fees 886

Types of Investment Companies Based on Portfolio Makeup 886 Common Stock Funds 886 Balanced Funds 886 Bood Funds 887 Money Market Funds 887

Breakdown by Fund Characteristics 888
Performance of Investment Companies 889
Analysis of Overall Performance 889
Impact of Fund Objectives 891
Market Timing Ability 891

Consistency of Performance 892 What Performance Studies Mean to You 893 Sources of Information 895 Global Investment Companies 901 Summary 901

Appendix 24A Mutual Funds Glossary 905

Relaxing the Assumptions 915

PART VII
EXTENSIONS AND APPLICATION OF ASSET
PRICING AND PORTFOLIO MODELS 912

Tideline

Chapter 25
Extensions and Testing of Asset Pricing Theories 914

Differential Borrowing and Lending Rates 915 Zero-Beta Model 916 Transaction Costs 917

Transaction Costs 917
Heterogeneous Expectations and Planning Periods 917
Taxes 918

Empirical Tests of the CAPM 919
Stability of Beta 919
Comparability of Published Estimates of Beta 921

Comparability of Published Estimates of Beta 921 Relationship Between Systematic Risk and Return 922 Effect of Skewness 922

Effect of Size, P/E, and Leverage 924
Effect of Book-to-Market Value: The Fama-French
Study 924

Study 924 Summary of CAPM Risk-Return Empirical Results 927 The Market Portfolio: Theory Versus Practice 927 Arbitrage Pricing Theory (APT) 930

Empirical Tests of the APT 933
Roll-Ross Study 933
Extensions of the Roll-Ross Tests 934
The APT and Anomalies 935
The Shanken Challenge to Testability of the APT 937

Chapter 26

Summary 938

Evaluation of Portfolio Performance 943

What Is Required of a Portfolio Manager? 944 Composite Portfolio Performance Measures 945 Portfolio Evaluation Before 1960 945 Treynor Portfolio Performance Measure 946

Sharpe Portfolio Performance Measure 949
Jensen Portfolio Performance Measure 951
Application of Portfolio Performance Measures 953

Components of Investment Performance 956
Factors That Affect Use of Performance
Measures 962

Benchmark Errors and Global Investing 963
A Demonstration of the Global Benchmark Problem 964
Implications of the Benchmark Problems 965
Reliability of Performance Measures 967
Evaluation of Bond Portfolio Performance 968

A Bond Market Line 968
Decomposing Portfolio Returns 971
Analyzing Sources of Return 973
Consistency of Performance 974
Required Characteristics of Benchmarks 975

Summary 976 Appendix A

Appendix A How to Become a Chartered Financial Analyst A-1 Appendix B

Code of Ethics and Standards of Professional Conduct B-1 Appendix C Interest Tables C-1

Appendix D
Standard Normal Probabilities D-1

Name Index 1-1 Subject Index 1-6

