

Contents

| | |
|--|------------|
| Preface | xix |
| Abbreviations | xxi |
| I INTRODUCTION TO FINANCIAL MARKETS | 1 |
| 1 The Financial System | 5 |
| 1.1 Participants | 5 |
| 1.1.1 End-users of the financial system | 5 |
| 1.1.2 General financial intermediaries | 7 |
| 1.1.3 Specialist financial intermediaries | 12 |
| 1.1.4 Market-makers | 16 |
| 1.2 Securities | 16 |
| 1.3 Markets | 20 |
| 1.3.1 The classification of financial markets | 20 |
| 1.3.2 Financial markets in the UK | 25 |
| 1.4 Trading arrangements | 38 |
| 1.4.1 Types of order | 39 |
| 1.4.2 Types of account | 39 |
| 1.4.3 Stock borrowing agreements | 41 |
| 1.4.4 Clearing and settlement of trades | 42 |
| 1.4.5 Official intervention in markets | 43 |
| 1.5 Regulation | 44 |
| 1.6 The financial system in a temporal context | 51 |

| | | |
|----------|--|-----------|
| 1.6.1 | The recent past: the Big Bang of October 1986 | 51 |
| 1.6.2 | The near future | 53 |
| | Appendix: The City Research Project 1991-95 | 69 |
| 2 | The market determination of discount rates | 79 |
| 2.1 | The price of time and risk | 79 |
| 2.2 | The expected real interest rate | 80 |
| 2.3 | The expected inflation rate | 82 |
| 2.4 | The expected liquidity premium | 83 |
| 2.5 | The expected risk premium | 84 |
| 2.6 | Interest rates and discount rates | 87 |
| 3 | Financial arithmetic | 89 |
| 3.1 | Future values: single payments | 89 |
| 3.1.1 | Simple interest | 89 |
| 3.1.2 | Compound interest: annual compounding | 90 |
| 3.1.3 | Compound interest: more frequent compounding | 90 |
| 3.1.4 | Flat and effective rates of interest | 92 |
| 3.2 | Present values: single payments | 92 |
| 3.2.1 | Present value: annual discounting | 92 |
| 3.2.2 | Present values: more frequent discounting | 93 |
| 3.3 | Future values: multiple payments | 93 |
| 3.3.1 | Irregular payments | 93 |
| 3.3.2 | Regular payments: annual payments with annual compounding | 94 |
| 3.3.3 | Regular payments: annual payments with more frequent compounding | 95 |
| 3.3.4 | Regular payments: more frequent payments and compounding | 96 |
| 3.4 | Present values: multiple payments | 96 |
| 3.4.1 | Irregular payments | 96 |
| 3.4.2 | Regular payments: annual payments with annual discounting | 97 |
| 3.4.3 | Regular payments: annual payments with more frequent discounting | 97 |
| 3.4.4 | Regular payments: more frequent payments and discounting | 98 |
| 3.4.5 | Perpetuities | 100 |
| 3.5 | Rates of return | 100 |

| | | |
|-----------|--|-----|
| 3.5.1 | Single-period rate of return | 100 |
| 3.5.2 | Internal rate of return or money-weighted rate of return | 101 |
| 3.5.3 | Time-weighted rate of return or geometric mean rate of return | 103 |
| Appendix: | A simple iterative method for calculating internal rates of return | 104 |

II THE ANALYSIS AND VALUATION OF SECURITIES 107

4 Money market securities 111

| | | |
|-------|---|-----|
| 4.1 | Securities quoted on a yield basis | 112 |
| 4.1.1 | Money market deposits | 112 |
| 4.1.2 | Negotiable certificates of deposit | 113 |
| 4.2 | Securities quoted on a discount basis | 116 |
| 4.3 | Recent innovations | 120 |

5 Bonds 123

| | | |
|-------|--|-----|
| 5.1 | Types of bond | 123 |
| 5.2 | The fair pricing of bonds | 127 |
| 5.3 | Clean and dirty bond prices | 128 |
| 5.4 | Yield measures on bonds | 129 |
| 5.4.1 | Current yield | 130 |
| 5.4.2 | Simple yield to maturity | 131 |
| 5.4.3 | Yield to maturity | 131 |
| 5.4.4 | Holding-period yield | 135 |
| 5.4.5 | Yield to par | 135 |
| 5.4.6 | Yield to call and yield to put | 135 |
| 5.4.7 | Yield to average life and yield to equivalent life | 136 |
| 5.4.8 | Index-linked yields | 138 |
| 5.5 | Yield curves | 141 |
| 5.5.1 | The yield to maturity yield curve | 142 |
| 5.5.2 | The coupon yield curve | 142 |
| 5.5.3 | The par yield curve | 142 |
| 5.5.4 | The spot (or zero-coupon) yield curve | 144 |

| | | |
|----------|---|------------|
| 5.5.5 | The forward yield curve | 146 |
| 5.5.6 | The annuity yield curve | 150 |
| 5.5.7 | Rolling yield curve | 150 |
| 5.6 | Theories of the yield curve | 152 |
| 5.6.1 | The expectations hypothesis | 152 |
| 5.6.2 | The liquidity preference theory | 153 |
| 5.6.3 | The segmentation or preferred habitat theory | 154 |
| 5.7 | Fitting the yield curve | 154 |
| 5.7.1 | Polynomial curve fitting | 154 |
| 5.7.2 | Regression analysis | 155 |
| 5.7.3 | Matrix modelling | 156 |
| 5.8 | Interest rate risk | 158 |
| 5.8.1 | Duration | 158 |
| 5.8.2 | Convexity | 164 |
| 5.8.3 | Dispersion | 166 |
| 5.9 | Floating rate notes | 166 |
| 5.10 | Recent innovations: the gilt repurchase market | 170 |
| 6 | Shares | 181 |
| 6.1 | Types of share in the firm | 181 |
| 6.2 | The financial structure of the firm | 183 |
| 6.2.1 | The income statement and statement of retained earnings | 183 |
| 6.2.2 | Inflation accounting | 184 |
| 6.2.3 | Depreciation | 184 |
| 6.2.4 | Corporation tax and corporate capital gains tax | 185 |
| 6.2.5 | The effect of accounting conventions on reported earnings | 188 |
| 6.2.6 | The balance sheet | 190 |
| 6.3 | The fair pricing of shares | 192 |
| 6.3.1 | Valuation based on expected dividends | 192 |
| 6.3.2 | Valuation based on expected earnings | 194 |
| 6.4 | Dividend policy | 196 |
| 6.5 | Earnings analysis | 198 |

| | | |
|----------|---|------------|
| 6.5.1 | Constant or normal growth models | 198 |
| 6.5.2 | Differential growth models | 201 |
| 6.5.3 | Forecasting earnings | 205 |
| 6.6 | The value of the firm: the effect of leverage | 206 |
| 7 | Foreign currency | 215 |
| 7.1 | The foreign exchange market | 215 |
| 7.1.1 | Spot foreign exchange transactions | 216 |
| 7.1.2 | Forward foreign exchange transactions | 219 |
| 7.2 | Exchange rate risk | 222 |
| 7.3 | Covering foreign exchange transactions | 226 |
| 7.3.1 | Covering forward transactions | 226 |
| 7.3.2 | Covering spot transactions | 228 |
| 7.4 | The fair pricing of foreign currency | 230 |
| 7.4.1 | Consistent cross exchange rates | 230 |
| 7.4.2 | Purchasing power parity | 231 |
| 7.4.3 | International Fisher effect | 234 |
| 7.4.4 | Covered interest rate parity | 235 |
| 7.4.5 | Uncovered interest rate parity | 236 |
| 8 | Forwards and futures | 239 |
| 8.1 | Forward and futures contracts | 239 |
| 8.1.1 | Forward contracts | 239 |
| 8.1.2 | Futures contracts | 240 |
| 8.2 | Financial futures contracts | 244 |
| 8.2.1 | Short-term interest rate futures | 247 |
| 8.2.2 | Long-term interest rate futures | 250 |
| 8.2.3 | Currency futures | 257 |
| 8.2.4 | Stock index futures | 257 |
| 8.3 | The fair pricing of forward and financial futures contracts | 260 |
| 8.3.1 | Fair pricing with no uncertainty | 260 |
| 8.3.2 | Futures prices and expected spot prices | 262 |
| 8.3.3 | Fair pricing of the short-term interest rate contract | 263 |

| | | |
|----------|--|------------|
| 8.3.4 | Fair pricing of the long-term interest rate contract | 264 |
| 8.3.5 | Fair pricing of the currency contract | 266 |
| 8.3.6 | Fair pricing of the stock index contract | 267 |
| 9 | Options, warrants and convertibles | 273 |
| 9.1 | Option contracts | 273 |
| 9.2 | Option combinations | 277 |
| 9.3 | Financial options contracts | 283 |
| 9.3.1 | Equity options | 288 |
| 9.3.2 | Interest-rate options | 291 |
| 9.3.3 | Currency options | 297 |
| 9.3.4 | Stock index options | 297 |
| 9.3.5 | Restricted-life traded options | 301 |
| 9.3.6 | Traditional options | 302 |
| 9.3.7 | Over-the-counter options | 302 |
| 9.4 | The fair pricing of options contracts | 303 |
| 9.4.1 | Factors influencing the premium | 303 |
| 9.4.2 | Boundary conditions for options | 304 |
| 9.4.3 | The binomial model of the fair European call option price | 309 |
| 9.4.4 | The Black-Scholes model of the fair European call option price | 312 |
| 9.4.5 | Properties of the Black-Scholes model: the Greeks | 316 |
| 9.4.6 | Pricing a European put option | 321 |
| 9.4.7 | Modifications to the Black-Scholes model | 322 |
| 9.5 | Exotic options | 327 |
| 9.6 | Warrants and convertibles | 334 |
| 9.6.1 | Warrants | 334 |
| 9.6.2 | Convertibles | 336 |
| | Appendix A: Accounting issues with options and futures contracts | 338 |
| | Appendix B: Taxation issues with options and futures contracts | 340 |
| | Appendix C: Standard normal distribution table | 342 |

| | |
|--|------------|
| 10 Synthetic securities | 349 |
| 10.1 The basic building blocks of synthetic securities | 349 |
| 10.2 Synthetic options and futures | 352 |
| 10.3 Swaps | 357 |
| 10.3.1 Interest rate swaps | 358 |
| 10.3.2 Basis swaps | 363 |
| 10.3.3 Currency swaps | 363 |
| 10.3.4 Asset swaps | 369 |
| 10.3.5 More esoteric swaps | 370 |
| 10.3.6 The risks involved in swaps | 371 |
| 10.3.7 The uses of swaps | 372 |
| 10.4 Forward rate agreements | 373 |
| 10.5 Caps, floors and collars | 375 |
| 10.6 Bundled and unbundled securities | 378 |
| 10.6.1 Bundled securities | 378 |
| 10.6.2 Unbundled securities | 380 |

III PORTFOLIO ANALYSIS, MANAGEMENT AND PERFORMANCE MEASUREMENT **385**

| | |
|--|------------|
| 11 Market efficiency: theory and evidence | 389 |
| 11.1 Allocative, operational and informational efficiency | 389 |
| 11.2 The EMH, the fair game model and random walk | 390 |
| 11.3 The EMH and information | 392 |
| 11.4 The EMH and an information-efficient equilibrium | 393 |
| 11.5 Tests of the efficient markets hypothesis | 394 |
| 11.5.1 Evidence favouring the efficient markets hypothesis | 394 |
| 11.5.2 Evidence against the efficient markets hypothesis | 398 |
| 11.5.3 Are the financial markets efficient? | 405 |

| | |
|---|------------|
| 12 Speculation and arbitrage | 415 |
| 12.1 Speculation | 415 |
| 12.1.1 The process of speculation | 415 |
| 12.1.2 Trading strategies with futures | 417 |
| 12.1.3 Trading strategies with options | 426 |
| 12.2 Arbitrage | 434 |
| 12.2.1 The process of arbitrage | 434 |
| 12.2.2 Arbitrage strategies with futures | 435 |
| 12.2.3 Arbitrage strategies with options | 439 |
| Appendix A: The collapse of Barings Bank | 441 |
| Appendix B: Technical analysis | 444 |
| 13 Portfolio analysis and asset pricing | 461 |
| 13.1 Portfolio analysis | 461 |
| 13.1.1 Choice under uncertainty: the consumption of risk and return | 461 |
| 13.1.2 Portfolios under uncertainty: the production of risk and return | 465 |
| 13.1.3 Diversification | 468 |
| 13.1.4 The minimum standard deviation portfolio opportunity set and the efficient set | 474 |
| 13.1.5 The efficient set when there is a riskless security | 476 |
| 13.1.6 Market equilibrium, portfolio optimality and the pricing of efficient portfolios | 477 |
| 13.1.7 Pricing inefficient portfolios and the decomposition of total risk | 482 |
| 13.2 Asset pricing | 489 |
| 13.2.1 The capital asset pricing model | 489 |
| 13.2.2 The multi-factor model | 501 |
| 13.2.3 The arbitrage pricing model | 501 |

| | |
|---|------------|
| 14 Portfolio management | 511 |
| 14.1 The functions of portfolio management | 511 |
| 14.2 Assessing the investing client's utility function | 514 |
| 14.3 Passive portfolio management | 519 |
| 14.3.1 Passive portfolio management for an expected utility-maximizing client | 519 |
| 14.3.2 Passive portfolio management for a safety-first client | 521 |
| 14.4 Active portfolio management and adjustment | 528 |
| 14.4.1 Active share portfolio management and adjustment | 528 |
| 14.4.2 Active treasury portfolio management | 537 |
| 14.4.3 Active bond portfolio management and adjustment | 538 |
| 14.5 Mixed active-passive portfolio management | 542 |
| 14.6 Investment management styles | 544 |
| 14.6.1 Traditional investment management | 545 |
| 14.6.2 Quantitative investment management | 547 |
| 14.7 Recent innovations: hedge funds and bear funds | 548 |
| Appendix: Investment-Objectives Questionnaire | 550 |
| 15 Portfolio performance measurement | 559 |
| 15.1 The components of portfolio performance measurement | 559 |
| 15.1.1 <i>Ex post</i> returns | 559 |
| 15.1.2 Adjusting for risk | 562 |
| 15.1.3 Benchmarks of comparison | 562 |
| 15.2 Measures of portfolio performance | 564 |
| 15.2.1 Performance measures based on risk-adjusted excess returns | 564 |
| 15.2.2 Performance measures based on alpha values | 567 |
| 15.3 The decomposition of total return | 570 |
| 15.4 Treasury performance measurement | 574 |
| 15.5 Asset-liability managed portfolios | 574 |
| 15.6 Portfolios containing financial futures and options contracts | 578 |
| 15.6.1 Individual treatment of futures | 578 |
| 15.6.2 Individual treatment of options | 579 |
| 15.6.3 A worked example | 580 |

| | | |
|-----------|--|------------|
| 15.7 | Performance measurement with multiple fund managers | 586 |
| 15.8 | The Roll critique of performance measurement | 588 |
| 15.9 | Evidence on the performance of fund managers | 588 |
| | Appendix: A note on the different uses of the geometric mean and the arithmetic mean | 590 |
| 16 | Hedging and efficient portfolio management | 597 |
| 16.1 | The objective of hedging | 597 |
| 16.2 | Money market hedges | 599 |
| 16.3 | Hedging using futures | 601 |
| 16.3.1 | Hedging with short-term interest rate futures contracts | 601 |
| 16.3.2 | Hedging with stock index futures contracts | 604 |
| 16.3.3 | Hedging with long-term interest rate futures contracts | 613 |
| 16.3.4 | Hedging with currency futures contracts | 617 |
| 16.4 | Hedging using options | 620 |
| 16.4.1 | Hedging with individual stock options contracts | 621 |
| 16.4.2 | Hedging with stock index options contracts | 627 |
| 16.4.3 | Hedging with short-term interest rate options contracts | 630 |
| 16.4.4 | Hedging with long-term interest rate options contracts | 631 |
| 16.4.5 | Hedging with currency options contracts | 632 |
| 16.5 | Hedging with swaps and swaptions | 633 |
| 16.6 | Hedging with FRAs | 637 |
| 16.7 | Hedging with caps, floors and collars | 637 |
| 16.8 | Portfolio insurance | 638 |
| 16.9 | Efficient portfolio management | 643 |
| IV | POSTSCRIPT | 655 |
| 17 | The failure of financial markets | 659 |
| 17.1 | The anatomy of the crash | 659 |
| 17.2 | The consequences of the crash | 661 |
| 17.3 | The causes of the crash | 663 |
| 17.4 | Conclusion | 669 |

| | |
|--|------------|
| 18 Recent developments in financial market analysis | 673 |
| 18.1 Value-at-risk analysis | 673 |
| 18.2 Speculative bubbles | 676 |
| 18.3 Volatility effects in financial markets | 678 |
| 18.4 Chaos | 682 |
| 18.5 Neural networks | 693 |

