CONTENTS

Foreword	xiii
Preface	XV
Acknowledgments	xvii
About the CFA Institute Investment Series	xix
CHAPTER 1 The Time Value of Money	1
Learning Outcomes	1
1. Introduction	1
 Interest Rates: Interpretation The Future Value of a Single Cash Flow 	2 4
3.1. The Frequency of Compounding	9
3.2. Continuous Compounding	11
3.3. Stated and Effective Rates	12
4. The Future Value of a Series of Cash Flows	13
4.1. Equal Cash Flows—Ordinary Annuity	14
4.2. Unequal Cash Flows	15
5. The Present Value of a Single Cash Flow	16
5.1. Finding the Present Value of a Single Cash Flow	16
5.2. The Frequency of Compounding	18
6. The Present Value of a Series of Cash Flows	19
6.1. The Present Value of a Series of Equal Cash Flows6.2. The Present Value of an Infinite Series of Equal	19
6.2. The Present Value of an Infinite Series of Equal Cash Flows—Perpetuity	24
6.3. Present Values Indexed at Times Other than $t = 0$	25
6.4. The Present Value of a Series of Unequal Cash Flows	26
7. Solving for Rates, Number of Periods, or Size of Annuity Payments	27
7.1. Solving for Interest Rates and Growth Rates	27
7.2. Solving for the Number of Periods	30
7.3. Solving for the Size of Annuity Payments	31
7.4. Review of Present and Future Value Equivalence	35
7.5. The Cash Flow Additivity Principle	37

		Contents

vi

8.	Summary Problems	38 38
	PTER 2 scounted Cash Flow Applications	43
	Learning Outcomes	43
1.	Introduction	43
2.	Net Present Value and Internal Rate of Return	44
	2.1. Net Present Value and the Net Present Value Rule	44
	2.2. The Internal Rate of Return and the Internal Rate of Return Rule	46
	2.3. Problems with the IRR Rule	49
3.	Portfolio Return Measurement	51
	3.1. Money-Weighted Rate of Return	52
,	3.2. Time-Weighted Rate of Return	53
4.	Money Market Yields	59
5.	Summary References	64
	Problems	65 65
	Trobellis	0)
	PTER 3	
Sta	tistical Concepts and Market Returns	69
	Learning Outcomes	69
1.	Introduction	70
2.	Some Fundamental Concepts	70
	2.1. The Nature of Statistics	70
	2.2. Populations and Samples	71
2	2.3. Measurement Scales	72
3.	Summarizing Data Using Frequency Distributions	73
4.	The Graphic Presentation of Data 4.1. The Histogram	81
	4.2. The Frequency Polygon and the Cumulative Frequency Distribution	82 83
5.	Measures of Central Tendency	86
	5.1. The Arithmetic Mean	86
	5.2. The Median	90
	5.3. The Mode	93
	5.4. Other Concepts of Mean	94
6.	Other Measures of Location: Quantiles	103
	6.1. Quartiles, Quintiles, Deciles, and Percentiles	103
	6.2. Quantiles in Investment Practice	108
7.	Measures of Dispersion	110
	7.1. The Range	111
	7.2. The Mean Absolute Deviation	111
	7.3. Population Variance and Population Standard Deviation	113
	7.4. Sample Variance and Sample Standard Deviation	116
	7.5. Semivariance, Semideviation, and Related Concepts	120

Contents	V11
101110111103	V 11

8. 9. 10. 11.	 7.6. Chebyshev's Inequality 7.7. Coefficient of Variation 7.8. The Sharpe Ratio Symmetry and Skewness in Return Distributions Kurtosis in Return Distributions Using Geometric and Arithmetic Means Summary References Problems 	121 123 125 129 134 138 140 141
CHAI	PTER 4	
Pro	bability Concepts	151
1. 2. 3. 4.	Learning Outcomes Introduction Probability, Expected Value, and Variance Portfolio Expected Return and Variance of Return Topics in Probability 4.1. Bayes' Formula 4.2. Principles of Counting Summary References Problems	151 152 152 175 184 184 188 192 194
	PTER 5	
Co	mmon Probability Distributions	199
1. 2. 3. 4. 5.	Learning Outcomes Introduction to Common Probability Distributions Discrete Random Variables 2.1. The Discrete Uniform Distribution 2.2. The Binomial Distribution Continuous Random Variables 3.1. Continuous Uniform Distribution 3.2. The Normal Distribution 3.3. Applications of the Normal Distribution 3.4. The Lognormal Distribution Monte Carlo Simulation Summary References Problems	199 200 200 202 204 214 218 224 226 232 239 240 241
	PTER 6 npling and Estimation	247
Jai		
1. 2.	Learning Outcomes Introduction Sampling	247 248 248

V111	Contents
V 111	Contents

	2.1. Simple Random Sampling	248
	2.2. Stratified Random Sampling	250
	2.3. Time-Series and Cross-Sectional Data	251
3.	Distribution of the Sample Mean	254
	3.1. The Central Limit Theorem	254
4.	Point and Interval Estimates of the Population Mean	258
	4.1. Point Estimators	258
	4.2. Confidence Intervals for the Population Mean	260
	4.3. Selection of Sample Size	266
5.	More on Sampling	268
	5.1. Data-Mining Bias	268
	5.2. Sample Selection Bias	271
	5.3. Look-Ahead Bias	272
	5.4. Time-Period Bias	272
6.	Summary	274
	References	276
	Problems	276
CHAI	PTER 7	
Hy	pothesis Testing	281
	Learning Outcomes	281
1.	Introduction	282
2.	Hypothesis Testing	282
3.	Hypothesis Tests Concerning the Mean	292
	3.1. Tests Concerning a Single Mean	292
	3.2. Tests Concerning Differences between Means	300
	3.3. Tests Concerning Mean Differences	304
4.	Hypothesis Tests Concerning Variance	308
	4.1. Tests Concerning a Single Variance	308
	4.2. Tests Concerning the Equality (Inequality) of Two Variances	310
5.	1	314
	5.1. Tests Concerning Correlation: The Spearman Rank	
	Correlation Coefficient	315
	5.2. Nonparametric Inference: Summary	317
6.	,	318
	References	320
	Problems	320
CHA	PTER 8	
Co	rrelation and Regression	327
	Learning Outcomes	327
1.		328
2.	Correlation Analysis	328
	2.1. Scatter Plots	328
	2.2. Correlation Analysis	329

	2.3. Calculating and Interpreting the Correlation Coefficient	332
45	2.4. Limitations of Correlation Analysis	334
4.	2.5. Uses of Correlation Analysis	337
	2.6. Testing the Significance of the Correlation Coefficient	345
3.	Linear Regression	348
	3.1. Linear Regression with One Independent Variable	348
	3.2. Assumptions of the Linear Regression Model	352
	3.3. The Standard Error of Estimate	354
	3.4. The Coefficient of Determination	357
	3.5. Hypothesis Testing	359
	3.6. Analysis of Variance in a Regression with One	
	Independent Variable	367
	3.7. Prediction Intervals	370
	3.8. Limitations of Regression Analysis	373
4.	Summary	373
	Problems	375
~~~		
	PTER 9	205
IVIU	ıltiple Regression and Issues in Regression Analysis	385
	Learning Outcomes	385
1.	Introduction	386
2.	Multiple Linear Regression	386
	2.1. Assumptions of the Multiple Linear Regression Model	392
	2.2. Predicting the Dependent Variable in a Multiple	
	Regression Model	398
	2.3. Testing whether All Population Regression Coefficients	
	Equal Zero	399
	2.4. Adjusted $R^2$	402
3.	Using Dummy Variables in Regressions	403
4.	Violations of Regression Assumptions	408
	4.1. Heteroskedasticity	408
	4.2. Serial Correlation	415
	4.3. Multicollinearity	419
	4.4. Heteroskedasticity, Serial Correlation, Multicollinearity:	
	Summarizing the Issues	422
5.	Model Specification and Errors in Specification	422
	5.1. Principles of Model Specification	422
	5.2. Misspecified Functional Form	423
	5.3. Time-Series Misspecification (Independent Variables	
	Correlated with Errors)	431
	5.4. Other Types of Time-Series Misspecification	435
6.	Models with Qualitative Dependent Variables	435
7.	Summary	438
	References	440
	Problems	441

Contents

CHAP	PTER 10	
Tin	ne-Series Analysis	459
	Learning Outcomes	459
1.	Introduction to Time-Series Analysis	460
2.	Challenges of Working with Time Series	462
3.	Trend Models	462
	3.1. Linear Trend Models	463
	3.2. Log-Linear Trend Models	466
	3.3. Trend Models and Testing for Correlated Errors	471
4.	Autoregressive (AR) Time-Series Models	472
	4.1. Covariance-Stationary Series	472
	4.2. Detecting Serially Correlated Errors in an Autoregressive Model	474
	4.3. Mean Reversion	477
	4.4. Multiperiod Forecasts and the Chain Rule of Forecasting	477
	4.5. Comparing Forecast Model Performance	481
	4.6. Instability of Regression Coefficients	482
5.	Random Walks and Unit Roots	485
	5.1. Random Walks	485
	5.2. The Unit Root Test of Nonstationarity	489
6.	Moving-Average Time-Series Models	494
	6.1. Smoothing Past Values with an <i>n</i> -Period Moving Average	494
	6.2. Moving-Average Time-Series Models for Forecasting	496
7.	Seasonality in Time-Series Models	499
8.	Autoregressive Moving-Average Models	504
9.	Autoregressive Conditional Heteroskedasticity Models	504
10.	Regressions with More than One Time Series	507
11.	Other Issues in Time Series	512
12.	Suggested Steps in Time-Series Forecasting	512
13.		514
	Problems	516
CHAI	PTER 11	
	roduction to Multifactor Models	525
	Learning Outcomes	525
1.	Introduction	525
2.	Multifactor Models and Modern Portfolio Theory	526
3.	Arbitrage Pricing Theory	527
4.	Multifactor Models: Types	533
7.	4.1. Factors and Types of Multifactor Models	533
	4.2. The Structure of Macroeconomic Factor Models	534
	4.3. The Structure of Fundamental Factor Models	537
5.	Multifactor Models: Selected Applications	541
).	5.1. Factor Models in Return Attribution	542
	5.2. Factor Models in Risk Attribution	545
		11)

Conte	nts		xi
	5.3.	Factor Models in Portfolio Construction	549
	5.4.	How Factor Considerations Can Be Useful in Strategic	
		Portfolio Decisions	551
6.	Sum	mary	552
	Refer	rences	554
	Prob	lems	554
Appe	ndices		557
Gloss	ary		567
Abou	t the l	Editors and Authors	579

581

583

About the CFA Program

Index