Contents

Part I Portfolio Management

1 Return 3
1.1 Introduction 3
1.2 Simple (Discrete) Investment Return 3
1.3 Continuous Compounded Investment Return 5
1.4 Investment Return Over Several Periods 6
1.5 Arithmetic Mean Return 7
1.6 Geometric Mean Return 9
1.7 Money-Weighted Return 11
1.8 Real Rate of Return 15
1.9 Expected Return 16
1.10 Summary 17
1.11 Problems 18
1.12 Solutions 20
Microsoft Excel Applications 25

2 Risk 29
2.1 Introduction 29
2.2 Variance and Standard Deviation 29
2.3 Average Return and Standard Deviation 38
2.4 Downside Risk 40
2.5 Value at Risk 45
2.6 Summary 51
2.7 Problems 52
2.8 Solutions 53
Appendix: Standard Normal Distribution Table 56
Cumulative Probabilities for a Standard Normal Distribution 56
Cumulative Probabilities for a Standard Normal Distribution 57
Microsoft Excel Applications 58

3 Other Investment Characteristics 63
3.1 Introduction 63
3.2 Properties of a Distribution 63
3.2.1 Normal Distribution 63
3.2.2 Skewness 64
3.2.3 Kurtosis 66
3.2.4 Lognormal Distribution 71
3.3 Market Characteristics 75
3.3.1 Information Efficiency of Financial Markets 75
3.3.2 The Random Walk 79
3.3.3 Behavioural Finance and Market Efficiency 82
3.3.4 Market Liquidity and Trading Costs 84
3.4 Summary 87
3.5 Problems 89
3.6 Solutions 91
Microsoft Excel Applications 96
References 98

4 Efficient Risky Portfolios 101
4.1 Introduction 101
4.2 Expected Return and Risk of a Two-Asset Portfolio 102
4.3 The Efficient Frontier 112
4.4 Expected Return and Risk of a Portfolio Consisting of Many Risky Assets 116
4.5 Diversification Effect 123
4.6 Summary 128
4.7 Problems 131
4.8 Solutions 133
Microsoft Excel Applications 136
References 142

5 Optimal Portfolio 145
5.1 Introduction 145
5.2 Risk Aversion 145
5.2.1 Concept of Risk Aversion 145
5.2.2 Utility Theory and Indifference Curves 147
5.3 The Optimal Risky Portfolio 153
5.4 The Risk-Free Investment: Capital Allocation Line Model 154
5.5 Homogeneous Expectations: Capital Market Line Model 166
5.6 Summary 171
5.7 Problems 172
5.8 Solutions 175
Microsoft Excel Applications 182
References 185

6 Capital Asset Pricing Model and Fama–French Model 187
6.1 Introduction 187
6.2 Capital Asset Pricing Model 188
6.2.1 Basics of the Model 188
6.2.2 Calculation and Interpretation of the Beta 189
6.2.3 The Security Market Line 195
6.2.4 Equilibrium Model 199
6.2.5 Applications of the CAPM in Corporate Finance 201
6.3 Fama–French Model 208
6.3.1 The Risk Premiums for Size and Value 208
6.3.2 Expected Rate of Return 209
6.4 Summary 214
6.5 Problems 216
6.6 Solutions 218
Microsoft Excel Applications 220
References 221
Online Sources 222

7 Portfolio Management Process 223
7.1 Introduction 223
7.2 Planning 224
7.2.1 Investment Objectives and Constraints 224
7.2.1.1 Risk Objectives 224
7.2.1.2 Return Objectives 228
7.2.1.3 Constraints 229
7.2.2 Investment Policy Statement 233
7.2.3 Capital Market Expectations 234
7.2.4 Strategic Asset Allocation 234
7.3 Execution 239
7.4 Feedback 239
7.4.1 Monitoring the Investment Policy Statement 239
7.4.2 Monitoring Capital Market Expectations 241
7.4.3 Rebalancing the Portfolio 241
7.4.4 Performance Evaluation 243
7.5 Performance Attribution of an Active Portfolio 246
7.6 Summary 249
7.7 Problems 251
7.8 Solutions 253
References 257

Part II Equity Securities

8 Dividend Discount Model 261
8.1 Introduction 261
8.2 Fundamentals of Equity Valuation 262
8.3 Growth Rate 265
8.4 One-Stage Dividend Discount Model 268

8.5 Two-Stage Dividend Discount Model 275
8.6 Summary 281
8.7 Problems 282
8.8 Solutions 283
References 287

9 Free Cash Flow Models 289
9.1 Introduction 289
9.2 Free Cash Flow to Equity Model 290
9.2.1 Overview 290
9.2.2 Definition and Calculation of the FCFE 290
9.2.3 Growth Rate of the FCFE 291
9.2.4 One-Stage FCFE Model 294
9.2.5 Two-Stage FCFE Model 297
9.3 Free Cash Flow to Firm Model 301
9.3.1 Definition and Calculation of Free Cash Flow to Firm 301
9.3.2 Growth Rate of the FCFF 303
9.3.3 One-Stage FCFF Model 304
9.3.4 Comparison Between FCFE and FCFF Models 310
9.4 Adjusted Present Value Model 310
9.5 Summary 316
9.6 Problems 318
9.7 Solutions 319
References 325

10 Multiples 327
10.1 Introduction 327
10.2 Price-to-Earnings Ratio 329
10.2.1 Definition 329
10.2.2 P/E Ratio Based on Forecast Fundamentals 332
10.2.3 P/E Ratio Based on Comparable Companies 335
10.3 Price/Earnings-to-Growth Ratio 338
10.4 Price-to-Book Ratio 342
10.4.1 Definition 342
10.4.2 P/B Ratio Based on Forecast Fundamentals 345
10.4.3 P/B Ratio Based on Comparable Companies 347
10.5 Enterprise Value EBITDA Ratio 350
10.6 Summary 355
10.7 Problems 356
10.8 Solutions 358
References 362
Online Sources 363

Part III Bonds

11 Bond Price and Yield 367
11.1 Introduction 367
11.2 Basic Features of a Bond 368
11.3 Different Types of Bonds 371
11.4 Pricing of Fixed-Rate Bonds 374
11.4.1 Pricing Fixed-Rate Bonds with a Fixed Risk-Adjusted Discount Rate 375
11.4.2 Pricing Fixed-Rate Bonds with Risk-Adjusted Discount Rates That Correspond to the Timing of the Cash Flows 383
11.4.3 Pricing of Zero-Coupon Bonds 387
11.5 Pricing of Floating-Rate Notes 389
11.6 Yield Measures for Fixed-Rate Bonds 394
11.7 Summary 400
11.8 Problems 402
11.9 Solutions 404
Microsoft Excel Applications 408
References 410
Online Sources 411

12 Duration and Convexity 413
12.1 Introduction 413
12.2 Analysis of the Risk Factors 413
12.2.1 Overview 413
12.2.2 Interest Rate Risk 415
12.2.3 Credit Risk 417
12.2.4 Market Liquidity Risk 419
12.3 Duration-Convexity Approach 421
12.4 Duration 423
12.4.1 Modified Duration and Macaulay Duration 423
12.4.2 Factors Affecting Duration and Price Volatility 427
12.5 Convexity 430
12.6 Applications 437
12.7 Summary 440
12.8 Problems 442
12.9 Solutions 443
Microsoft Excel Applications 445
References 447
Online Sources 447

Part IV Derivatives

13 Futures, Forwards, and Swaps 451
13.1 Introduction 451
13.2 Use of Derivatives 452
13.3 Futures and Forwards 454
13.3.1 Futures Versus Forwards 454
13.3.2 Profit and Loss 457
13.3.3 Leverage Effect 459
13.3.4 Pricing 460
13.3.5 Valuation 464
13.3.6 Hedging 466
13.4 Swaps 469
13.5 Summary 471
13.6 Problems 473
13.7 Solutions 474
References 477

14 Options: Basics and Valuation 479
14.1 Introduction 479
14.2 Basic Characteristics 479
14.3 Profit and Loss 481
14.3.1 Call Option 481
14.3.2 Put Option 487
14.4 Intrinsic Value and Time Value 492
14.5 Binomial Option Pricing Model 498
14.6 Black–Scholes Option Pricing Model 504
14.7 Put–Call Parity 509
14.8 Leverage Effect 510
14.9 Option Price Sensitivities 511
14.9.1 Delta 512
14.9.2 Gamma 516
14.9.3 Vega 520
14.9.4 Rho 522
14.9.5 Theta 523
14.10 Summary 523
14.11 Problems 527
14.12 Solutions 528
Microsoft Excel Applications 533
References 534
Online Sources 535

15 Option Strategies 537
15.1 Introduction 537
15.2 Synthetic Equity 537
15.3 Synthetic Call and Put Option 540
15.4 Covered Call 541
15.4.1 Profit and Loss 542
15.4.2 Objectives 547
15.5 Protective Put 548
15.6 Collar 552
15.7 Bull and Bear Spreads 556
15.7.1 Bull Spread 557
15.7.2 Bear Spread 561
15.7.3 Spread Strategy with Volatile Share Prices 566
15.8 Straddle 567
15.8.1 Long Straddle 567
15.8.2 Short Straddle 571
15.8.3 Breakeven Share Price and Volatility 575
15.9 Effects of Exercising Options on the Strategy 576
15.10 Selection of the Option Strategy 577
15.11 Summary 578
15.12 Problems 581
15.13 Solutions 583
References 586
Online Sources 586

Index 587