

Contents

Preface	v
Part A. Capital Markets	
CHAPTER 1	
Portfolio Theory	
G.M. Constantinides and A.G. Malliaris,	1
1. Introduction	1
2. The early contributions	2
3. Mean–variance portfolio selection	4
4. Two-fund separation	8
5. Mean–variance portfolio with a riskless asset	12
6. The capital asset pricing model	14
7. Theoretical justification of mean–variance analysis, mutual fund separation and the CAPM	16
8. Consumption and portfolio selection in continuous time	19
9. The Intertemporal Asset Pricing Model (ICAPM) and the Arbitrage Pricing Theory (APT)	23
10. Market imperfections	25
11. Concluding remarks	26
Acknowledgements	27
References	27
CHAPTER 2	
Finite State Securities Market Models and Arbitrage	
V. Naik,	31
1. Introduction	31
2. The model	33
3. Arbitrage and security prices in a frictionless market	36
4. Arbitrage and security prices in a model with transactions costs	47
5. Optimal portfolio choice in a finite state model: the static optimization approach	53
6. Concluding remarks	61
Appendix	61
Acknowledgements	62
References	62

CHAPTER 3

Capital Growth Theory

N.H. Hakansson and W.T. Ziemba,

65

1. Introduction	65
2. Origins of the model	66
3. The model and its basic properties	66
4. Conditions for capital growth	72
5. Relationship to other long-run investment models	73
6. Relationship to intertemporal consumption–investment models	75
7. Growth vs. security	77
8. Applications	78
9. Summary	82
References	82

CHAPTER 4

The Arbitrage Pricing Theory and Multifactor Models of Asset Returns

G. Connor and R.A. Korajczyk,

87

1. Introduction	87
2. Strict and approximate factor models	87
3. Derivation of the pricing restriction	93
4. Empirical analysis of the APT	102
5. Other empirical topics	125
6. Applications	133
7. Conclusions	136
Acknowledgements	137
References	137

CHAPTER 5

Theory and Empirical Testing of Asset Pricing Models

W.E. Ferson,

145

1. Introduction	145
2. Asset pricing models: a selective review and integration	146
3. Methodology and tests of asset pricing models	162
4. Conclusions	186
Acknowledgements	186
Appendix: Gauss™ code for the GMM	186
References	191

CHAPTER 6

International Portfolio Choice and Asset Pricing: An Integrative Survey

R.M. Stulz,	201
1. Introduction	201
2. The case of no differences in consumption and investment opportunity sets	202
3. The implications of differences in consumption opportunity sets	208
4. Barriers to international investment	216
5. An assessment of the current state of international finance	219
Acknowledgements	221
References	221

CHAPTER 7

A Discrete Time Synthesis of Derivative Security Valuation Using a Term Structure of Futures Prices

P.P. Carr and R.A. Jarrow,	225
1. Introduction	225
2. The general framework	227
3. Existing models	242
4. Implementation	245
5. Summary	247
References	247

CHAPTER 8

Pricing Interest Rate Options

R. Jarrow,	251
1. Introduction	251
2. The model: terminology and notation	252
3. Zero curve arbitrage	256
4. Option pricing	265
5. Empirical specifications	267
6. Conclusions	271
References	271


CHAPTER 9

Term Structure of Interest Rates and the Pricing of Fixed Income Claims and Bonds

T.A. Marsh,	273
1. Introduction	273
2. Brief overview of asset valuation methods applied to bonds	276

3. Arbitrage-free restrictions on default-free bond prices	281
4. Calibrating bond pricing dynamics with the observed term structure	292
5. Equilibrium models	298
6. Sources of interest rate uncertainty: how many factors?	304
7. Summary and discussion	307
Acknowledgements	309
References	309
CHAPTER 10	
Program Trading and Stock Index Arbitrage	
L. Canina and S. Figlewski,	315
1. Introduction	315
2. Stock index futures contracts and program trading	316
3. Stock index arbitrage in theory	320
4. Empirical evidence on index futures pricing	326
5. Program trading and volatility	332
6. Conclusions	337
Acknowledgements	337
References	338
CHAPTER 11	
Mortgage Backed Securities	
W.N. Torous,	341
1. Introduction	341
2. Mortgages	342
3. Mortgage backed securities	346
4. Mortgage prepayments	350
5. Valuation	352
6. Summary	355
Acknowledgements	355
Bibliography	355
CHAPTER 12	
Market Microstructure	
D. Easley and M. O'Hara,	357
1. Introduction	357
2. Walrasian (batch) models	358
3. Sequential trade models	369
4. Applications	372
5. Conclusions and future research	378
Acknowledgements	380
References	380

CHAPTER 13


Financial Decision-Making in Markets and Firms: A Behavioral Perspective

W.F.M. De Bondt and R.H. Thaler,	385
1. Introduction	385
2. Micro-foundations of behavioral finance: a sampler	389
3. Investor psychology and market prices	392
4. Financial decision-making in corporations	399
5. Conclusions	403
Acknowledgements	405
References	405

CHAPTER 14

Volatility

S.F. LeRoy and D.G. Steigerwald,	411
1. Introduction	411
2. Variance-bounds tests of capital market efficiency	413
3. Returns tests	417
4. Orthogonality tests	418
5. Monte Carlo tests	422
6. Conclusions	430
Acknowledgements	432
References	432

CHAPTER 15

Asset and Liability Allocation in a Global Environment

J.M. Mulvey and W.T. Ziemba,	435
1. Introduction	435
2. Asset allocation framework	443
3. Integrating assets and liabilities	453
4. Solution strategies	455
5. Conclusions	459
Acknowledgements	460
References	460

CHAPTER 16

Stock Market Crashes

A.W. Kleidon,	465
1. Introduction	465
2. Evidence from experimental markets	468
3. Potential explanations of stock market crashes	472
4. Responses to crashes	483

5. Conclusions	489
Acknowledgements	491
References	491
CHAPTER 17	
On the Predictability of Common Stock Returns: World-Wide Evidence	
G. Hawawini and D.B. Keim,	497
1. Introduction	497
2. Cross-sectional return predictability	498
3. Time series return predictability: seasonal patterns	519
4. Time series return predictability: return autocorrelations	529
5. Time series return predictability: forecasting with ex-ante observable variables	534
6. Concluding remarks	535
Acknowledgements	536
References	537
CHAPTER 18	
Efficiency of Sports and Lottery Betting Markets	
D.B. Hausch and W.T. Ziembra,	545
1. Introduction	545
2. Extent of gambling in USA	548
3. Racetrack betting markets	549
4. The football betting market	568
5. The basketball betting market	571
6. Lotteries	572
Acknowledgements	576
References	576
CHAPTER 19	
Performance Evaluation	
M. Grinblatt and S. Titman,	581
1. Introduction	581
2. Measures based solely on returns	582
3. Computing performance when portfolio weights are observable	601
4. Conclusions and directions for future research	605
References	607

CHAPTER 20

Market Manipulation**J.A. Cherian and R.A. Jarrow****611**

- 1. Introduction 611
- 2. A classification scheme 612
- 3. A review 624
- 4. Further examples 626
- 5. Summary and conclusions 628
- References 629

Part B. Corporate Finance

CHAPTER 21

Real Options**G. Sick****631**

- 1. Introduction 631
- 2. Primary principles in valuation 634
- 3. Derivative asset-pricing techniques 648
- 4. Examples 677
- 5. Concluding remarks 687
- Acknowledgements 688
- References 689

CHAPTER 22

Corporate Financial Structure, Incentives and Optimal Contracting**F. Allen and A. Winton****693**

- 1. Introduction 693
- 2. Costly state verification and agency 694
- 3. Adverse selection 700
- 4. The allocation of ownership and control among investors 704
- 5. The allocation of risk 712
- 6. Acquisition of information 714
- 7. Concluding remarks 716
- Acknowledgements 717
- References 717

CHAPTER 23

Financing Investment Under Asymmetric Information**K. Daniel and S. Titman****721**

- 1. Introduction 721
- 2. Model description 723

3. Analysis of the model	724
4. Further extensions of the model strategy space	736
5. Money burning models in the finance literature	745
6. Debt and the pecking order hypothesis	748
7. Conclusions	756
Acknowledgements	757
Appendix A — Proofs of propositions	757
Appendix B — The efficient combination of signals	763
References	766

CHAPTER 24

Financial Structure and the Tax System

P. Swoboda and J. Zechner	767
1. Introduction	767
2. Tax systems and capital structure equilibria under certainty	768
3. Taxes and international equilibrium	776
4. The effects of uncertainty	778
5. Multiperiod models	784
6. Extensions	787
References	790

CHAPTER 25

Dividend Policy

F. Allen and R. Michaely	793
1. Introduction	793
2. The Miller–Modigliani dividend irrelevance proposition	800
3. Taxes	802
4. Asymmetric information — signaling and adverse selection models	818
5. Incomplete contracts — agency models	826
6. Transaction costs and other explanations	828
7. Concluding remarks	832
Acknowledgements	834
References	834

CHAPTER 26

Mergers and Acquisitions: Strategic and Informational Issues

D. Hirshleifer	839
1. Introduction	839
2. An empirical synopsis	841
3. Tender offers and share tendering decisions	843
4. Competitive bidding	857
5. Means of payment	871

6. Target financing, managerial voting power and private benefits of control	872
7. Omitted topics and further references	877
8. Conclusions	878
Appendix: Pivotality and bidder profits	881
Acknowledgements	882
References	882

CHAPTER 27

Financial Structure and Product Market Competition

V. Maksimovic	887
1. Introduction	887
2. Conflicts of interest and industry equilibrium	890
3. Financial structure and implicit contracts	895
4. Conflicts of interest and commitment	901
5. Agency costs and product market strategies	909
6. Empirical tests	914
Acknowledgements	918
References	918

CHAPTER 28

Financial Distress, Bankruptcy and Reorganization

L.W. Senbet and J.K. Seward	921
1. Introduction and overview	921
2. Legal and economic ramifications of the U.S. Bankruptcy Code	925
3. Bankruptcy and corporate financial policy	928
4. Private methods of resolving financial distress	931
5. Court-supervised methods of resolving financial distress or formal reorganizations	942
6. An assessment of the impact of financial distress on the behavior of corporate managers	951
Appendix	955
Acknowledgements	958
References	958

CHAPTER 29

Empirical Methods of Event Studies in Corporate Finance

R. Thompson	963
1. Introduction	963
2. Sources of data for empirical investigations	965
3. The conceptual foundation of empirical methods used in event studies	966
4. Details of the empirical model	969
5. Issues in event study methods	970

6. Concluding remarks	988
Acknowledgements	989
References	989
CHAPTER 30	
Initial Public Offerings	
R.G. Ibbotson and J.R. Ritter	993
1. Introduction	993
2. New issues underpricing	994
3. Reasons for new issues underpricing	995
4. 'Hot issue' markets	1002
5. Long-run performance	1003
6. Going public as a stage in the life cycle of a firm's external financing	1007
7. Contractual forms and the going public process	1010
8. Summary	1012
Acknowledgements	1013
References	1013
CHAPTER 31	
Seasoned Equity Offerings: A Survey	
B.E. Eckbo and R.W. Masulis	1017
1. Introduction	1017
2. Trends in aggregate corporate financing activity	1018
3. Flotation methods and costs	1025
4. Valuation effects of SPO announcements	1041
5. The choice of equity flotation method	1051
6. The timing of SPOs	1056
7. Market microstructure effects	1059
8. Conclusions	1061
Appendix. Summary of empirical observations on seasoned public offerings	1063
Acknowledgements	1067
References	1067
CHAPTER 32	
Financial Intermediation and the Market for Credit	
A.V. Thakor	1073
1. Introduction	1073
2. Brokerage and financial intermediaries	1075
3. Qualitative asset transformation and financial intermediation	1080
4. Guarantees, QAT and financial intermediation	1082
5. Liquidity creation and claims transformation	1092

6. Conclusions	1100
Acknowledgments	1101
References	1101
CHAPTER 33	
The U.S. Savings and Loan Crisis	
D.H. Pyle	1105
1. Introduction	1105
2. A predisposition to failure	1105
3. The role of legislation and regulation in worsening the S&L crisis	1113
4. Concluding remarks	1123
Acknowledgements	1124
References	1124
Biographical Information	1127
Subject Index	1139
Contents of previous volumes	1161