

Contents

Part 1 INTRODUCTION 1

Chapter 1

INTRODUCTION 2

Outline of the Book 2

The Economic Theory of Choice: An
Illustration under Certainty 4

Conclusion 8

Multiple Assets and Risk 8

Questions and Problems 9

Bibliography 10

Chapter 2

FINANCIAL SECURITIES 11

Types of Marketable Financial Securities 11

The Return Characteristics of Alternative
Security Types 19

Stock Market Indexes 21

Bond Market Indexes 22

Conclusion 23

Chapter 3

FINANCIAL MARKETS 24

Trading Mechanics 24

Margin 27

Markets 30

Trade Types and Costs 36

Conclusion 38

Part 2 PORTFOLIO ANALYSIS 39

Section 1 MEAN VARIANCE PORTFOLIO THEORY 41

Chapter 4

THE CHARACTERISTICS OF THE
OPPORTUNITY SET UNDER RISK 42

Determining the Average Outcome 43

A Measure of Dispersion 44

Variance of Combinations of Assets 47

Characteristics of Portfolios in General 50

Two Concluding Examples 59

Conclusion 62

Questions and Problems 62

Bibliography 64

Examples and Applications 85

Three Examples 89

Conclusion 92

Questions and Problems 92

Bibliography 93

Chapter 5

DELINEATING EFFICIENT PORTFOLIOS 65

Combinations of Two Risky Assets

Revisited: Short Sales Not Allowed 65

The Shape of the Portfolio Possibilities

Curve 74

The Efficient Frontier with Riskless

Lending and Borrowing 81

Chapter 6

TECHNIQUES FOR CALCULATING
THE EFFICIENT FRONTIER 95

Short Sales Allowed with Riskless
Lending and Borrowing 96

Short Sales Allowed: No Riskless
Lending and Borrowing 100

Riskless Lending and Borrowing
with Short Sales Not Allowed 100

No Short Selling and No Riskless
Lending and Borrowing 101

The Incorporation of Additional
Constraints 102

An Example 103

Conclusion 106

Appendix A: An Alternative Definition of Short Sales **106**
 Appendix B: Determining the Derivative **107**
 Appendix C: Solving Systems of Simultaneous Equations **111**

Appendix D: A General Solution **114**
 Appendix E: Quadratic Programming and Kuhn–Tucker Conditions **118**
 Questions and Problems **121**
 Bibliography **122**

Section 2 SIMPLIFYING THE PORTFOLIO SELECTION PROCESS 125

Chapter 7
 THE CORRELATION STRUCTURE OF SECURITY RETURNS—THE SINGLE-INDEX MODEL **126**
 The Inputs to Portfolio Analysis **127**
 Single-Index Models: An Overview **128**
 Characteristics of the Single-Index Model **133**
 Estimating Beta **135**
 The Market Model **148**
 An Example **149**
 Questions and Problems **150**
 Bibliography **152**

Chapter 8
 THE CORRELATION STRUCTURE OF SECURITY RETURNS—MULTI-INDEX MODELS AND GROUPING TECHNIQUES **155**
 Multi-index Models **156**
 Average Correlation Models **162**
 Mixed Models **163**
 Fundamental Multi-index Models **163**
 Conclusion **169**
 Appendix A: Procedure for Reducing Any Multi-index Model to a Multi-index Model with Orthogonal Indexes **169**

Appendix B: Mean Return, Variance, and Covariance of a Multi-index Model **170**
 Questions and Problems **172**
 Bibliography **173**

Chapter 9
 SIMPLE TECHNIQUES FOR DETERMINING THE EFFICIENT FRONTIER **176**
 The Single-index Model **177**
 Security Selection with a Purchasable Index **188**
 The Constant Correlation Model **189**
 Other Return Structures **192**
 An Example **192**
 Conclusion **193**
 Appendix A: Single-index Model—Short Sales Allowed **194**
 Appendix B: Constant Correlation Coefficient—Short Sales Allowed **196**
 Appendix C: Single-index Model—Short Sales Not Allowed **197**
 Appendix D: Constant Correlation Coefficient—Short Sales Not Allowed **199**
 Appendix E: Single-index Model, Short Sales Allowed, and a Market Asset **201**
 Questions and Problems **201**
 Bibliography **202**

Section 3 SELECTING THE OPTIMUM PORTFOLIO 205

Chapter 10
 ESTIMATING EXPECTED RETURNS **206**
 Aggregate Asset Allocation **206**
 Forecasting Individual Security Returns **212**
 Portfolio Analysis with Discrete Data **214**
 Appendix: The Ross Recovery Theorem—A New Approach to Using Market Data to Calculate Expected Return **215**
 Bibliography **218**

Chapter 11
 HOW TO SELECT AMONG THE PORTFOLIOS IN THE OPPORTUNITY SET **220**

Choosing Directly **220**
 An Introduction to Preference Functions **221**
 Risk Tolerance Functions **224**
 Safety First **226**
 Maximizing the Geometric Mean Return **232**
 Value at Risk (VaR) **234**
 Utility and the Equity Risk Premium **235**
 Optimal Investment Strategies with Investor Liabilities **237**
 Liabilities and Safety-First Portfolio Selection **241**
 Simulations in Portfolio Choice **241**

Conclusion	247
Appendix: The Economic Properties of Utility Functions	247

Relative Risk Aversion and Wealth	249
Questions and Problems	249
Bibliography	250

Section 4 WIDENING THE SELECTION UNIVERSE 255

Chapter 12

INTERNATIONAL DIVERSIFICATION 256

Historical Background	257
Calculating the Return on Foreign Investments	257
The Risk of Foreign Securities	261
Market Integration	267
Returns from International Diversification	268
The Effect of Exchange Risk	269

Return Expectations and Portfolio Performance	270
Emerging Markets	272
Other Evidence on Internationally Diversified Portfolios	276
Sovereign Funds	278
Models for Managing International Portfolios	280
Conclusion	283
Questions and Problems	284
Bibliography	285

Part 3 MODELS OF EQUILIBRIUM IN THE CAPITAL MARKETS 289

Chapter 13

THE STANDARD CAPITAL ASSET PRICING MODEL 290

The Assumptions Underlying the Standard Capital Asset Pricing Model (CAPM)	290
The CAPM	291
Prices and the CAPM	300
Conclusion	302
Appendix: Appropriateness of the Single-Period Asset Pricing Model	304
Questions and Problems	308
Bibliography	309

Chapter 14

NONSTANDARD FORMS OF CAPITAL ASSET PRICING MODELS 311

Short Sales Disallowed	312
Modifications of Riskless Lending and Borrowing	312
Personal Taxes	322
Nonmarketable Assets	324
Heterogeneous Expectations	326
Non-Price-Taking Behavior	327
Multiperiod CAPM	327
The Multi-beta CAPM	328
Consumption CAPM	328
Conclusion	330
Appendix: Derivation of the General Equilibrium with Taxes	331
Questions and Problems	333
Bibliography	334

Chapter 15

EMPIRICAL TESTS OF EQUILIBRIUM MODELS 340

The Models—Ex Ante Expectations and Ex Post Tests	340
Empirical Tests of the CAPM	341
Testing Some Alternative Forms of the CAPM Model	352
Testing the Posttax Form of the CAPM Model	353
Some Reservations about Traditional Tests of General Equilibrium Relationships and Some New Research	356
Conclusion	358
Questions and Problems	359
Bibliography	360

Chapter 16

THE ARBITRAGE PRICING MODEL APT—A MULTIFACTOR APPROACH TO EXPLAINING ASSET PRICES 364

APT—What Is It?	364
Estimating and Testing APT	369
APT and CAPM	381
Recapitulation	382
Term Structure Factor	392
Credit Risk Factor	392
Foreign Exchange [FX] Carry	393
Value Factor	393
Size Factor	393
Momentum Factor	393
Volatility Factor	394
Liquidity Factor	394

Inflation Factor **395**
GDP Factor **395**
Equity Risk Premium **396**
Limitations of Factor Investing **396**
Factor Investing Summary **397**
Conclusion **397**

Appendix A: A Simple Example of
Factor Analysis **397**
Appendix B: Specification of the APT with
an Unobserved Market Factor **399**
Questions and Problems **400**
Bibliography **401**

Part 4 SECURITY ANALYSIS AND PORTFOLIO THEORY 409

Chapter 17

EFFICIENT MARKETS **410**
Early Development **411**
The Next Stages of Theory **412**
Recent Theory **414**
Some Background **415**
Testing the EMH **416**
Tests of Return Predictability **417**
Tests on Prices and Returns **417**
Monthly Patterns **419**
Announcement and Price Return **431**
Methodology of Event Studies **432**
Strong-Form Efficiency **437**
Market Rationality **440**
Conclusion **442**
Questions and Problems **442**
Bibliography **443**

Chapter 18

THE VALUATION PROCESS **454**
Discounted Cash Flow Models **455**
Cross-Sectional Regression Analysis **467**
An Ongoing System **471**
Conclusion **476**
Questions and Problems **476**
Bibliography **477**

Chapter 19

EARNINGS ESTIMATION **481**
The Elusive Number Called Earnings **481**
The Importance of Earnings **484**
Characteristics of Earnings and
Earnings Forecasts **487**
Conclusion **495**
Questions and Problems **496**
Bibliography **496**

Chapter 20

BEHAVIORAL FINANCE, INVESTOR DECISION
MAKING, AND ASSET PRICES **499**
Prospect Theory and Decision
Making under Uncertainty **499**

Biases from Laboratory Experiments **502**
Summary of Investor Behavior **505**
Behavioral Finance and Asset
Pricing Theory **506**
Bibliography **513**

Chapter 21

INTEREST RATE THEORY AND
THE PRICING OF BONDS **517**
An Introduction to Debt Securities **518**
The Many Definitions of Rates **519**
Bond Prices and Spot Rates **526**
Determining Spot Rates **528**
The Determinants of Bond Prices **530**
Collateral Mortgage Obligations **546**
The Financial Crisis of 2008 **547**
Conclusion **549**
Appendix A: Special Considerations
in Bond Pricing **549**
Appendix B: Estimating Spot Rates **550**
Appendix C: Calculating Bond Equivalent
Yield and Effective Annual Yield **552**
Questions and Problems **552**
Bibliography **553**

Chapter 22

THE MANAGEMENT OF BOND
PORTFOLIOS **557**
Duration **557**
Protecting against Term Structure Shifts **565**
Bond Portfolio Management of
Yearly Returns **569**
Swaps **578**
Appendix A: Duration Measures **580**
Appendix B: Exact Matching Programs **584**
Appendix C: Bond-Swapping
Techniques **586**
Appendix D: Convexity **587**
Questions and Problems **588**
Bibliography **589**

Chapter 23

OPTION PRICING THEORY **592**
Types of Options **592**

Some Basic Characteristics of	
Option Values	598
Valuation Models	603
Artificial or Homemade Options	614
Uses of Options	615
Conclusion	618
Appendix A: Derivation of the	
Binomial Formula	618
Appendix B: Derivation of the	
Black–Scholes Formula	621
Questions and Problems	623
Bibliography	624

Part 5 EVALUATING THE INVESTMENT PROCESS 647

Chapter 25

MUTUAL FUNDS 648

Open-End Mutual Funds	649
Closed-End Mutual Funds	652
Exchange-Traded Funds (ETFs)	655
Conclusion	658
Bibliography	658

Chapter 26

EVALUATION OF PORTFOLIO PERFORMANCE 660

Evaluation Techniques	661
A Manipulation-Proof Performance Measure	669
Timing	670
Holding Measures of Timing	674
Multi-index Models and Performance Measurement	675
Using Holdings Data to Measure Performance Directly	678
Time-Varying Betas	679
Conditional Models of Performance Measurement, Bayesian Analysis, and Stochastic Discount Factors	679
Bayesian Analysis	680
Stochastic Discount Factors	681
What's a Researcher to Do?	681
Measuring the Performance of Active Bond Funds	682
The Performance of Actively Managed Mutual Funds	682

Chapter 24

THE VALUATION AND USES OF FINANCIAL FUTURES 630

Description of Financial Futures	630
Valuation of Financial Futures	634
The Uses of Financial Futures	639
Nonfinancial Futures and Commodity Funds	643
Questions and Problems	644
Bibliography	645

How Have Mutual Funds Done?	682
The Persistence of Performance	684
Persistence	684
Appendix: The Use of APT Models to Evaluate and Diagnose Performance	689
Questions and Problems	693
Bibliography	693

Chapter 27

EVALUATION OF SECURITY ANALYSIS 699

Why the Emphasis on Earnings?	700
The Evaluation of Earnings Forecasts	701
Evaluating the Valuation Process	708
Conclusion	711
Questions and Problems	712
Bibliography	712

Chapter 28

PORTFOLIO MANAGEMENT REVISITED 714

Managing Stock Portfolios	715
Active Management	718
Passive Versus Active	719
International Diversification	720
Bond Management	720
Bond and Stock Investment with a Liability Stream	723
Bibliography	728

Index 731