PART ONE
INTRODUCTION 1

1 The Investment Environment 2
2 Markets and Instruments 27
3 How Securities Are Traded 64
4 Mutual Funds and Other Investment Companies 103
5 History of Interest Rates and Risk Premiums 131

PART TWO
PORTFOLIO THEORY 153

6 Risk and Risk Aversion 154
7 Capital Allocation between the Risky Asset and the Risk-Free Asset 183
8 Optimal Risky Portfolios 207

PART THREE
EQUILIBRIUM IN CAPITAL MARKETS 257

9 The Capital Asset Pricing Model 258
10 Single-Index and Multifactor Models 292
11 Arbitrage Pricing Theory 320
12 Market Efficiency 340
13 Empirical Evidence on Security Returns 382

PART FOUR
FIXED-INCOME SECURITIES 413

14 Bond Prices and Yields 414
15 The Term Structure of Interest Rates 452
16 Managing Bond Portfolios 482

PART FIVE
SECURITY ANALYSIS 531

17 Macroeconomic and Industry Analysis 532
18 Equity Valuation Models 562
19 Financial Statement Analysis 606

PART SIX
OPTIONS, FUTURES, AND OTHER DERIVATIVES 647

20 Options Markets: Introduction 648
21 Option Valuation 696
22 Futures Markets 739
23 Futures and Swaps: A Closer Look 766

PART SEVEN
ACTIVE PORTFOLIO MANAGEMENT 805

24 Portfolio Performance Evaluation 806
25 International Diversification 848
26 The Process of Portfolio Management 873
27 The Theory of Active Portfolio Management 916

Appendix A
Quantitative Review 939

Appendix B
CFA Citations 976

Appendix C
Glossary 978

Name Index 990

Subject Index 994

PART ONE
INTRODUCTION 1

CHAPTER 1
THE INVESTMENT ENVIRONMENT 2
1.1 Real Assets versus Financial Assets 3
1.2 Financial Markets and the Economy 5
Consumption Timing 5
Allocation of Risk 5
Separation of Ownership and Management 6
1.3 Clients of the Financial System 7
The Household Sector 7
The Business Sector 8
The Government Sector 9
1.4 The Environment Responds to Clientele Demands 10
Financial Intermediation 10
Investment Banking 12
Financial Innovation and Derivatives 13
Response to Taxation and Regulation 14
1.5 Markets and Market Structure 16
1.6 Ongoing Trends 17
Globalization 17
Securitization 18
Financial Engineering 20
Computer Networks 21
Summary 22
Key Terms 22
Websites 22
Problems 23

CHAPTER 2
MARKETS AND INSTRUMENTS 27
2.1 The Money Market 28
Treasury Bills 28
Bank Discount Yields 29
Certificates of Deposit 31
Commercial Paper 32
Bankers' Acceptances 32
Eurodollars 32

Repos and Reverses 33
Federal Funds 33
Brokers' Calls 33
The LIBOR Market 33
Yield on Money Market Instruments 34
2.2 The Bond Market 34
Treasury Notes and Bonds 35
Federal Agency Debt 35
International Bonds 37
Municipal Bonds 38
Corporate Bonds 40
Mortgages and Mortgage-Backed Securities 41
2.3 Equity Securities 44
Common Stock as Ownership Shares 44
Characteristics of Common Stock 44
Stock Market Listings 45
Preferred Stock 46
2.4 Stock and Bond Market Indexes 46
Stock Market Indexes 46
Dow Jones Averages 48
Standard & Poor's Indexes 51
Other U.S. Market-Value Indexes 52
Equally Weighted Indexes 52
Foreign and International Stock Market Indexes 53
Bond Market Indicators 53
2.5 Derivative Markets 54
Options 55
Futures Contracts 56
Summary 58
Key Terms 59
Websites 59
Problems 60
E-Investments: Interest Rates 63

CHAPTER 3
HOW SECURITIES ARE TRADED 64
3.1 How Firms Issue Securities 65
Investment Bankers and Underwriting 65

Shelf Registration 66
Private Placements 66
Initial Public Offerings 66
3.2 Where Securities Are Traded 70
The Secondary Markets 70
The Over-the-Counter Market 72
The Third and Fourth Markets 73
The National Market System 74
3.3 Trading on Exchanges 75
The Participants 75
Types of Orders 76
Market Orders 76
Limit Orders 76
Specialists and the Execution of Trades 77
Block Sales 79
The SuperDOT System 79
Settlement 80
3.4 Trading on the OTC Market 80
Market Structure in Other Countries 81
The London Stock Exchange 82
The Tokyo Stock Exchange 82
Globalization of Stock Markets 83
3.5 Trading Costs 83
3.6 Buying on Margin 88
3.7 Short Sales 90
3.8 Regulation of Securities Markets 92
Government Regulation 92
Self-Regulation and Circuit Breakers 94
Insider Trading 95
Summary 96
Key Terms 97
Websites 97
Problems 98
E-Investments: Listing Requirements 102
Short Sales 102

CHAPTER 4
MUTUAL FUNDS AND OTHER INVESTMENT COMPANIES 103
4.1 Investment Companies 104
4.2 Types of Investment Companies 104
Unit Investment Trusts 105
Managed Investment Companies 105
Other Investment Organizations 107

Commingled Funds 107
Real Estate Investment Trusts (REITs) 108
4.3 Mutual Funds 108
Investment Policies 108
Money Market Funds 108
Equity Funds 109
Fixed-Income Funds 109
Balanced and Income Funds 109
Asset Allocation Funds 109
Index Funds 109
Specialized Sector Funds 109
How Funds Are Sold 111
4.4 Costs of Investing in Mutual Funds 111
Fee Structure 111
Front-End Load 112
Back-End Load 112
Operating Expenses 112
12b-1 Charges 112
Fees and Mutual Fund Returns 113
4.5 Taxation of Mutual Fund Income 115
4.6 Exchange-Traded Funds 116
4.7 Mutual Fund Investment Performance: A First Look 117
4.8 Information on Mutual Funds 121
Summary 126
Key Terms 127
Websites 127
Problems 127
E-Investments: Mutual Fund Report 130

CHAPTER 5
HISTORY OF INTEREST RATES AND RISK PREMIUMS 131
5.1 Determinants of the Level of Interest Rates 132
Real and Nominal Rates of Interest 132
The Equilibrium Real Rate of Interest 133
The Equilibrium Nominal Rate of Interest 134
Bills and Inflation, 1954–1999 135
Taxes and the Real Rate of Interest 135
5.2 Risk and Risk Premiums 136
5.3 The Historical Record 138
Bills, Bonds, and Stocks, 1926–1999 138
5.4 Real versus Nominal Risk 143

Summary 145
Key Terms 145
Websites 145
Problems 146
Appendix: Continuous Compounding 149
E-Investments: Inflation and Rates 151

PART TWO
PORTFOLIO THEORY 153

CHAPTER 6
RISK AND RISK AVERSION 154
6.1 Risk and Risk Aversion 155
Risk with Simple Prospects 155
Risk, Speculation, and Gambling 156
Risk Aversion and Utility Values 157
6.2 Portfolio Risk 162
Asset Risk versus Portfolio Risk 162
A Review of Portfolio Mathematics 163
Rule 1 163
Rule 2 163
Rule 3 163
Rule 4 164
Rule 5 166
Summary 167
Key Terms 167
Problems 167
Appendix A: A Defense of Mean-Variance Analysis 171
Appendix B: Risk Aversion, Expected Utility, and the St. Petersburg Paradox 178

CHAPTER 7
CAPITAL ALLOCATION BETWEEN THE RISKY ASSET AND THE RISK-FREE ASSET 183
7.1 Capital Allocation across Risky and Risk-Free Portfolios 184
7.2 The Risk-Free Asset 186
7.3 Portfolios of One Risky Asset and One Risk-Free Asset 186
7.4 Risk Tolerance and Asset Allocation 190
7.5 Passive Strategies: The Capital Market Line 196
Summary 199
Key Terms 200
Problems 200

CHAPTER 8
OPTIMAL RISKY PORTFOLIOS 207
8.1 Diversification and Portfolio Risk 208
8.2 Portfolios of Two Risky Assets 209
8.3 Asset Allocation with Stocks, Bonds, and Bills 217
The Optimal Risky Portfolio with Two Risky Assets and a Risk-Free Asset 218
8.4 The Markowitz Portfolio Selection Model 223
Security Selection 223
8.5 The Spreadsheet Model 229
Calculation of Expected Return and Variance 229
Capital Allocation and the Separation Property 233
Asset Allocation and Security Selection 235
8.6 Optimal Portfolios with Restrictions on the Risk-Free Asset 236
Summary 240
Key Terms 240
Websites 241
Problems 241
E-Investments: Risk Comparisons 249
Appendix A: The Power of Diversification 249
Appendix B: The Insurance Principle: Risk-Sharing versus Risk-Pooling 252
Appendix C: The Fallacy of Time Diversification 254

PART THREE
EQUILIBRIUM IN CAPITAL MARKETS 257

CHAPTER 9
THE CAPITAL ASSET PRICING MODEL 258
9.1 Demand for Stocks and Equilibrium Prices 259
Sigma's Demand for Shares 260
Index Funds' Demand for Stock 261
Equilibrium Prices and the Capital Asset Pricing Model 263
9.2 The Capital Asset Pricing Model 263
Why Do All Investors Hold the Market Portfolio? 265
The Passive Strategy Is Efficient 266
The Risk Premium of the Market Portfolio 267

Expected Returns on Individual Securities 267
The Security Market Line 272
9.3 Extensions of the CAPM 275
The CAPM with Restricted Borrowings: The Zero-Beta Model 275
Lifetime Consumption and the CAPM 278
9.4 The CAPM and Liquidity 279
Summary 284
Key Terms 286
Websites 286
Problems 286
E-Investments: Beta Comparisons 291

CHAPTER 10
SINGLE-INDEX AND MULTIFACTOR MODELS 292
10.1 A Single-Index Security Market 293
Systematic Risk versus Firm-Specific Risk 293
Estimating the Index Model 296
The Index Model and Diversification 299
10.2 The CAPM and the Index Model 301
Actual Returns versus Expected Returns 301
The Index Model and Realized Returns 301
The Index Model and the Expected Return–Beta Relationship 302
10.3 The Industry Version of the Index Model 304
Predicting Betas 307
10.4 Multifactor Models 308
Empirical Foundation of Multifactor Models 309
Theoretical Foundations of Multifactor Models 312
Empirical Models and the ICAPM 313
Summary 313
Key Terms 314
Websites 314
Problems 314
E-Investments: Comparing Volatilities and Beta Coefficients 319

CHAPTER 11
ARBITRAGE PRICING THEORY 320
11.1 Arbitrage Opportunities and Profits 321
11.2 The APT and Well-Diversified Portfolios 324

Well-Diversified Portfolios 324
Betas and Expected Returns 326
The Security Market Line 328
11.3 Individual Assets and the APT 330
11.4 The APT and the CAPM 331
11.5 A Multifactor APT 332
Summary 334
Key Terms 334
Problems 335

CHAPTER 12
MARKET EFFICIENCY 340
12.1 Random Walks and the Efficient Market Hypothesis 341
Competition as the Source of Efficiency 342
Versions of the Efficient Market Hypothesis 342
12.2 Implications of the EMH for Investment Policy 343
Technical Analysis 343
Fundamental Analysis 348
Active versus Passive Portfolio Management 349
The Role of Portfolio Management in an Efficient Market 350
12.3 Event Studies 351
12.4 Are Markets Efficient? 355
The Issues 355
The Magnitude Issue 355
The Selection Bias Issue 355
The Lucky Event Issue 356
Tests of Predictability in Stock Market Returns 357
Returns over Short Horizons 357
Returns over Long Horizons 358
Predictors of Broad Market Returns 358
Portfolio Strategies and Market Anomalies 359
The Small-Firm-in-January Effect 360
The Neglected-Firm Effect and Liquidity Effects 361
Book-to-Market Ratios 361
Reversals 362
Risk Premiums or Anomalies? 363
Inside Information 365
Post–Earnings-Announcement Price Drift 365

Anomalies or Data Mining? 366
A Behavioral Interpretation 367
Mutual Fund Performance 368
So, Are Markets Efficient? 374
Summary 374
Key Terms 375
Websites 375
Problems 375
E-Investments:
Earnings Surprises 381

CHAPTER 13
EMPIRICAL EVIDENCE ON SECURITY RETURNS 382
13.1 The Index Model and the Single-Factor APT 383
The Expected Return–Beta Relationship 383
Setting Up the Sample Data 383
Estimating the SCL 384
Estimating the SML 384
Tests of the CAPM 385
The Market Index 386
Measurement Error in Beta 388
The EMH and the CAPM 391
13.2 Tests of Multifactor CAPM and APT 391
13.3 The Anomalies Literature: Risk Premiums or Inefficiencies? 393
The Assault 393
The Defense 394
Accounting for Human Capital and Cyclical Variations in Asset Betas 397
13.4 Time-Varying Volatility 399
13.5 The Equity Premium Puzzle 402
Expected versus Realized Returns 403
Survivorship Bias 404
13.6 Survivorship Bias and Tests of Market Efficiency 405
Summary 407
Key Terms 409
Websites 409
Problems 409
E-Investments:
Funds 412

PART FOUR
FIXED-INCOME SECURITIES 413

CHAPTER 14
BOND PRICES AND YIELDS 414
14.1 Bond Characteristics 415

Treasury Bonds and Notes 415
Accrued Interest and Quoted Bond Prices 417
Corporate Bonds 417
Call Provisions on Corporate Bonds 418
Convertible Bonds 419
Puttable Bonds 419
Floating-Rate Bonds 419
Preferred Stock 419
Other Issuers 420
International Bonds 420
Innovation in the Bond Market 421
Reverse Floaters 421
Asset-Backed Bonds 421
Catastrophe Bonds 421
Indexed Bonds 421
14.2 Bond Pricing 422
An Example: Bond Pricing 424
14.3 Bond Yields 426
Yield to Maturity 426
Yield to Call 427
Realized Compound Yield versus Yield to Maturity 429
14.4 Bond Prices over Time 430
Yield to Maturity versus Holding-Period Return 431
Zero-Coupon Bonds 432
After-Tax Returns 434
14.5 Default Risk and Bond Pricing 434
Junk Bonds 436
Determinants of Bond Safety 436
Bond Indentures 438
Sinking Funds 438
Subordination of Further Debt 439
Dividend Restrictions 439
Collateral 439
Yield to Maturity and Default Risk 440
Summary 442
Key Terms 443
Websites 443
Problems 443
E-Investments:
Bond Ratings and Yields 451

CHAPTER 15
THE TERM STRUCTURE OF INTEREST RATES 452
15.1 The Term Structure under Certainty 453

Bond Pricing 453
Holding-Period Returns 456
Forward Rates 457
15.2 Interest Rate Uncertainty and Forward Rates 459
15.3 Theories of the Term Structure 461
The Expectations Hypothesis 461
Liquidity Preference 461
Market Segmentation and Preferred Habitat Theories 462
15.4 Interpreting the Term Structure 464
15.5 Forward Rates as Forward Contracts 467
15.6 Measuring the Term Structure 469
Summary 472
Key Terms 473
Websites 473
Problems 474
E-Investments: Yield Curve 481

CHAPTER 16
MANAGING BOND PORTFOLIOS 482
16.1 Interest Rate Risk 483
Interest Rate Sensitivity 483
Duration 485
What Determines Duration? 489
Rule 1 for Duration 491
Rule 2 for Duration 491
Rule 3 for Duration 491
Rule 4 for Duration 492
Rule 5 for Duration 492
Rule 6 for Duration 492
Rule 7 for Duration 493
Rule 8 for Duration 493
16.2 Convexity 493
Why Do Investors Like Convexity? 496
Duration and Convexity of Callable Bonds 497
16.3 Passive Bond Management 498
Bond-Index Funds 499
Immunization 500
Net Worth Immunization 501
Cash Flow Matching and Dedication 507
Other Problems with Conventional Immunization 508
16.4 Active Bond Management 509
Sources of Potential Profit 509
Horizon Analysis 510

Contingent Immunization 512
16.5 Interest Rate Swaps 513
16.6 Financial Engineering and Interest Rate Derivatives 516
Summary 518
Key Terms 518
Websites 519
Problems 519
E-Investments: Bonds 529

PART FIVE
SECURITY ANALYSIS 531

CHAPTER 17
MACROECONOMIC AND INDUSTRY ANALYSIS 532
17.1 The Global Economy 533
17.2 The Domestic Macroeconomy 535
17.3 Demand and Supply Shocks 536
17.4 Federal Government Policy 538
Fiscal Policy 538
Monetary Policy 539
Supply-Side Policies 539
17.5 Business Cycles 540
The Business Cycle 540
Economic Indicators 542
17.6 Industry Analysis 545
Defining an Industry 546
Sensitivity to the Business Cycle 547
Industry Life Cycles 550
Start-Up Stage 551
Consolidation Stage 551
Maturity Stage 552
Relative Decline 552
Industry Structure and Performance 553
Threat of Entry 553
Rivalry between Existing Competitors 553
Pressure from Substitute Products 553
Bargaining Power of Buyers 553
Bargaining Power of Suppliers 554
Summary 554
Key Terms 554
Websites 554
Problems 555
E-Investments: Economic Indicators 561

CHAPTER 18
EQUITY VALUATION MODELS 562
18.1 Balance Sheet Valuation Methods 563
18.2 Intrinsic Value versus Market Price 564
18.3 Dividend Discount Models 565
The Constant-Growth DDM 566
Convergence of Price to Intrinsic Value 568
Stock Prices and Investment Opportunities 569
Life Cycles and Multistage Growth Models 572
18.4 Price–Earnings Ratio 576
The Price–Earnings Ratio and Growth Opportunities 576
P/E Ratios and Stock Risk 579
Pitfalls in P/E Analysis 581
Combining P/E Analysis and the DDM 582
Other Comparative Valuation Ratios 582
Price-to-Book Ratio 583
Price-to-Cash-Flow Ratio 583
Price-to-Sales Ratio 584
18.5 Corporate Finance and the Free Cash Flow Approach 585
18.6 Inflation and Equity Valuation 588
18.7 The Aggregate Stock Market 592
Explaining Past Behavior 592
Forecasting the Stock Market 593
Summary 594
Key Terms 595
Websites 595
Problems 596
E-Investments: Equity Valuation 604

CHAPTER 19
FINANCIAL STATEMENT ANALYSIS 606
19.1 The Major Financial Statements 607
The Income Statement 607
The Balance Sheet 607
The Statement of Cash Flows 609
19.2 Accounting versus Economic Earnings 611
19.3 Return on Equity 611
Past versus Future ROE 611
Financial Leverage and ROE 611
19.4 Ratio Analysis 613
Decomposition of ROE 613
Turnover and Other Asset Utilization Ratios 615
Liquidity and Coverage Ratios 617

Market Price Ratios 618
Choosing a Benchmark 620
19.5 Economic Value Added 620
19.6 An Illustration of Financial Statement Analysis 622
19.7 Comparability Problems 624
Inventory Valuation 625
Depreciation 626
Inflation and Interest Expense 627
Quality of Earnings 628
International Accounting Conventions 628
19.8 Value Investing: The Graham Technique 631
Summary 632
Key Terms 633
Websites 633
Problems 634
E-Investments: Financial Statement Analysis 646

PART SIX
OPTIONS, FUTURES, AND OTHER DERIVATIVES 647

CHAPTER 20
OPTIONS MARKETS: INTRODUCTION 648
20.1 The Option Contract 649
Option Trading 651
American and European Options 653
Adjustments in Option Contract Terms 653
The Option Clearing Corporation 654
Other Listed Options 654
Index Options 654
Futures Options 656
Foreign Currency Options 656
Interest Rate Options 656
20.2 Values of Options at Expiration 657
Call Options 657
Put Options 658
Option versus Stock Investments 660
20.3 Option Strategies 662
Protective Put 662
Covered Calls 664
Straddle 667
Spreads 667
Collars 669
20.4 The Put-Call Parity Relationship 671
20.5 Optionlike Securities 674

Callable Bonds 674
Convertible Securities 675
Warrants 677
Collateralized Loans 678
Leveraged Equity and Risky Debt 680
20.6 Financial Engineering 680
20.7 Exotic Options 683
Asian Options 683
Barrier Options 683
Lookback Options 683
Currency-Translated Options 684
Binary Options 684
Summary 684
Key Terms 684
Websites 685
Problems 685
E-Investments: Options and Straddles 695

CHAPTER 21
OPTION VALUATION 696
21.1 Option Valuation: Introduction 697
Intrinsic and Time Values 697
Determinants of Option Values 698
21.2 Restrictions on Option Values 699
Restrictions on the Value of a Call Option 700
Early Exercise and Dividends 701
Early Exercise of American Puts 702
21.3 Binomial Option Pricing 703
Two-State Option Pricing 703
Generalizing the Two-State Approach 70
21.4 Black-Scholes Option Valuation 708
The Black-Scholes Formula 709
Dividends and Call Option Valuation 715
Put Option Valuation 716
21.5 Using the Black-Scholes Formula 718
Hedge Ratios and the Black-Scholes Formula 718
Portfolio Insurance 719
Hedging Bets on Mispriced Options 723
21.6 Empirical Evidence on Option Pricing 728
Summary 729
Key Terms 730
Websites 730
Problems 730
E-Investments: Black-Scholes Option Pricing 738

CHAPTER 22
FUTURES MARKETS 739
22.1 The Futures Contract 740
The Basics of Futures Contracts 740
Existing Contracts 741
22.2 Mechanics of Trading in Futures Markets 744
The Clearinghouse and Open Interest 744
Marking to Market and the Margin Account 747
Cash versus Actual Delivery 749
Regulations 749
Taxation 750
22.3 Futures Markets Strategies 750
Hedging and Speculation 750
Basis Risk and Hedging 752
22.4 The Determination of Futures Prices 753
The Spot-Futures Parity Theorem 753
Spreads 756
Forward versus Futures Pricing 757
22.5 Futures Prices versus Expected Spot Prices 758
Expectations Hypothesis 759
Normal Backwardation 759
Contango 759
Modern Portfolio Theory 760
Summary 760
Key Terms 761
Websites 761
Problems 762
E-Investments: Contract Specifications for Financial Futures and Options 765

CHAPTER 23
FUTURES AND SWAPS: A CLOSER LOOK 766
23.1 Foreign Exchange Futures 767
The Markets 767
Interest Rate Parity 767
Using Futures to Manage Exchange Rate Risk 771
23.2 Stock-Index Futures 773
The Contracts 773
Creating Synthetic Stock Positions: An Asset Allocation Tool 774
Empirical Evidence on Pricing of Stock-Index Futures 776
Index Arbitrage and the Triple-Witching Hour 779

Using Index Futures to Hedge Systematic Risk 781
23.3 Interest Rate Futures 782
Hedging Interest Rate Risk 782
Other Interest Rate Futures 784
23.4 Commodity Futures Pricing 786
Pricing with Storage Costs 786
Discounted Cash Flow Analysis for Commodity Futures 788
23.5 Swaps 790
Credit Risk in the Swap Market 793
Swap Variations 794
Summary 795
Key Terms 796
Websites 796
Problems 797
E-Investments: Describing Different Swaps 803

PART SEVEN
ACTIVE PORTFOLIO MANAGEMENT 805

CHAPTER 24
PORTFOLIO PERFORMANCE EVALUATION 806
24.1 Measuring Investment Returns 807
Time-Weighted Returns versus Dollar-Weighted Returns 807
Arithmetic versus Geometric Averages 808
24.2 The Conventional Theory of Performance Evaluation 811
The M^2 Measure of Performance 813
Sharpe's Measure as the Criterion for Overall Portfolios 815
Appropriate Performance Measures in Three Scenarios 816
Relationships among the Various Performance Measures 819
Actual Performance Measurement: An Example 819
Realized Returns versus Expected Returns 820
24.3 Performance Measurement with Changing Portfolio Composition 822
24.4 Market Timing 823
24.5 Performance Attribution Procedures 825
Asset Allocation Decisions 828
Sector and Security Selection Decisions 828
Summing Up Component Contributions 829

24.6 Style Analysis 831
24.7 Morningstar's Risk-Adjusted Rating 833
24.8 Evaluating Performance Evaluation 834
Summary 836
Key Terms 837
Websites 837
Problems 837
E-Investments:
Performance of Mutual Funds 847

CHAPTER 25
INTERNATIONAL DIVERSIFICATION 848
25.1 International Investments 849
The World Equity Portfolio 849
International Diversification 849
Techniques for Investing Internationally 851
Exchange Rate Risk 854
Passive and Active International Investing 858
Security Analysis 862
Factor Models and International Investing 863
Equilibrium in International Capital Markets 864
Summary 867
Key Terms 867
Websites 867
Problems 868
E-Investments:
International Equity 872

CHAPTER 26
THE PROCESS OF PORTFOLIO MANAGEMENT 873
26.1 Making Investment Decisions 874
Objectives 874
Individual Investors 874
Personal Trusts 874
Mutual Funds 875
Pension Funds 875
Endowment Funds 876
Life Insurance Companies 876
Non–Life Insurance Companies 878
Banks 878
26.2 Constraints 878
Liquidity 879
Investment Horizon 879

Regulations 879
Tax Considerations 880
Unique Needs 880
26.3 Asset Allocation 880
Policy Statements 881
Taxes and Asset Allocation 881
26.4 Managing Portfolios of Individual Investors 882
Human Capital and Insurance 882
Investment in Residence 882
Saving for Retirement and the Assumption of Risk 883
Retirement Planning Models 883
Manage Your Own Portfolio or Rely on Others? 886
Tax Sheltering 886
The Tax-Deferral Option 886
Tax-Deferred Retirement Plans 887
Deferred Annuities 887
Variable and Universal Life Insurance 889
26.5 Pension Funds 890
Defined Contribution Plans 890
Defined Benefit Plans 891
Alternative Perspectives on Defined Benefit Pension Obligations 892
Pension Investment Strategies 893
Investing in Equities 894
Wrong Reasons to Invest in Equities 895
26.6 Future Trends in Portfolio Management 895
Summary 897
Key Terms 898
Websites 899
Problems 899

E-Investments:
Personal Diversification 914
Appendix: Popular Advice and Survey Evidence 914

CHAPTER 27
THE THEORY OF ACTIVE PORTFOLIO MANAGEMENT 916
27.1 The Lure of Active Management 917
27.2 Objectives of Active Portfolios 918
27.3 Market Timing 919
Valuing Market Timing as an Option 921
The Value of Imperfect Forecasting 922
27.4 Security Selection: The Treynor-Black Model 923
Overview of the Treynor-Black Model 923
Portfolio Construction 924
27.5 Multifactor Models and Active Portfolio Management 931
27.6 Imperfect Forecasts of Alpha Values and the Use of the Treynor-Black Model in Industry 932
Summary 933
Key Terms 934
Problems 934

APPENDIX A
Quantitative Review 939

APPENDIX B
References to CFA Questions 976

APPENDIX C
Glossary 978

Name Index 990

Subject Index 994