Business and Economics

Subtitle Goes Here
Business and Economics

Subtitle Goes Here

Fourth Edition

Author Name
Boston University

Author Name
University of California, San Diego

Author Name
Boston college
This book is dedicated to my students who inspire me.

—Author Name
List of Maps

| Map 1 | European Countries | 5 |
| Map 2 | Europe and Africa  | 8 |
| Map 3 | North America      | 14 |
| Map 4 | South America      | 15 |
| Map 5 | Central America    | 16 |
| Map 6 | European Countries | 5 |
| Map 7 | Europe and Africa  | 8 |
| Map 8 | North America      | 14 |
| Map 1 | South America      | 15 |
| Map 1 | Central America and the Carribean Islands | 16 |
| Map 1 | European Countries | 5 |
| Map 2 | Europe and Africa  | 8 |
| Map 3 | North America      | 14 |
| Map 4 | South America      | 15 |
| Map 5 | Central America    | 16 |
| Map 6 | European Countries | 5 |
| Map 7 | Europe and Africa  | 8 |
| Map 8 | North America      | 14 |

**Career Connections Boxes**
- Europe and Africa 8
- North America 14
- South America 15
- Central America 16
- European Countries 5
- Europe and Africa 8
- North America 14

**Ethics Boxes**
- Europe and Africa 8
- North America 14
- South America 15
- Central America 16
- European Countries 5
- Europe and Africa 8
- North America 14
Brief Contents

Preface 1

PART ONE
Elements of Investments 1
1 Investments: Background and Issues 2
2 Financial Markets and Instruments 20
3 How Security are Traded 53
4 Investors and the Investment Process 87

PART TWO
Portfolio Theory 110
5 Risk and Return Past and Future 111
6 Efficient Diversification 133
7 Capital Assets Pricing and Arbitrage Pricing Theory 164
8 The Efficient Market Hypothesis 194

PART THREE
Fixed Income Securities 224
9 Bond Prices and Yields 225
10 Managing Fixed Income Investments 262

PART FOUR
Security Analysis 290
11 Macroeconomic and Industry Analysis 291
12 Efficient Diversification 133
13 Capital Assets Pricing and Arbitrage Pricing Theory 164
14 The Efficient Market Hypothesis 194

PART FIVE
Elements of Investments 1
1 Investments: Background and Issues 2
2 Financial Markets and Instruments 20
3 How Security are Traded 53
4 Investors and the Investment Process 87

PART SIX
Portfolio Theory 110
5 Risk and Return Past and Future 111
6 Efficient Diversification 133
7 Capital Assets Pricing and Arbitrage Pricing Theory 164
8 The Efficient Market Hypothesis 194

APPENDIXES
A Sources of Financial and Economic Information 225
B References 262
C Mathematical Tables 262

INDEXES 1
Table of Contents

Preface x
About the Authors x

PART ONE
ELEMENTS OF INVESTMENTS 1

Chapter 1
Portfolio Theory 1
1.1 Real Assets versus Financial Assets 3
1.2 A Taxonomy of Financial Assets 4
1.3 Financial Markets and the Economy 5
   Consumption Timing 00
   Allocation of Risk 00
   Separation of Ownership and Management 00
1.4 The Investment Process 3
1.5 Markets Are Competitive 4
   The Risk-Return Trade-Off 00
   Efficient Markets 00
1.6 The Players 10
   Financial Intermediaries 00
   Investment Bankers 00
1.7 Markets and Market Structure 12
   Direct Search Markets 00
   Broketed Markets 00
   Dealer Markets 00
   Auction Markets 00
1.8 Recent Trends 14
   Globalization 00
   Securitization 00
   Financial Engineering 00
1.9 Outline of the Text 18
   Summary

Appendix A
Investments in Nontraditional Asset Groups
   Real Estate 19
   Precious Metals 19

PART TWO
ELEMENTS OF INVESTMENTS 1

Chapter 3
Portfolio Theory 1
1.1 Real Assets versus Financial Assets 3
1.2 A Taxonomy of Financial Assets 4
1.3 Financial Markets and the Economy 5
   Consumption Timing 00
   Allocation of Risk 00
   Separation of Ownership and Management 00
1.4 The Investment Process 3
1.5 Markets Are Competitive 4
   The Risk-Return Trade-Off 00
   Efficient Markets 00
1.6 The Players 10
   Financial Intermediaries 00
   Investment Bankers 12
1.7 Markets and Market Structure 12
   Direct Search Markets 00

Appendix A
Investments in Nontraditional Asset Groups
   Real Estate 19
   Precious Metals 19
About the Authors

**Author Name**  
*Boston University*

One dictionary’s definition of speculation is the assumption of considerable business risk in obtaining commensurate gain. While this definition is fine linguistically it is vague if we cannot specify what is meant by considerable risk an commensurate gain process consists broadly speaking of tow tasks. One is security and market analysis, by which we assess the risk and expected return of the entire set of available investment vehicles. The second is construction of the optimal portfolio of assets where we identify the set of efficient portfolios those with the best risk return characteristics. We start our analysis of investments with the latter task and discuss the specifics of security industry process consists broadly speaking of tow tasks. One is security and market analysis, by which we assess the risk and expected return of the entire set of available investment vehicles. The second is construction of the optimal portfolio of assets security industry.

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Investment strategy for an individual or for an institution involves market timing, asset allocation, and security selection. Investors formulate strategies according to capital market expectations and investor specific circumstances such as tax obligations. Investment strategy also calls for portfolio monitoring performance evaluation and decisions on portfolio adjustment.

Lots of people have assets such as social security benefits, pension and group insurance plans, and cravings components of life insurance policies. Yet they exercise limited control, if any, on the investment decisions of these plans. The funds that secure pension and life insurance plans are managed by institutional investors.

While there is no way to overcome them objective difficulties completely it is clear that to obtain reasonably reliable performance measures we need to:

1. Maximize the number of observations by taking more frequent return readings.
2. Specify the exact makeup of the portfolio to obtain better estimates of the risk parameters at each observation period.

A simple example demonstrates the procedure. Assume the total market value of an initial portfolio is $300,000. Of that $90,000 is invested in the Ready Assets money market found a rise free asset. The remaining $210,000 is in risky securities, by $113,400 in the Vanguard market index fund called the Index Trust 500 Portfolio and $96,600 in Shearson Lehamn’s High Yield Bond Fund. The remaining $210,000 is in risky securities, by $113,400 in the Vanguard market index fund called the Index Trust 500 Portfolio and $96,600 in Shearson Lehamn’s High Yield.

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John McCreary
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Teresa Palmer
*Illinois State University*

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*Western Carolina University*
We received help from many people as we prepared this book. An insightful group of reviewers commented on this and previous editions of this text. Their comments and suggestions improved the exposition of the material considerably. These reviewers all deserve special thanks for their contributions.

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For granting us permission to include many of their examination questions in the text, we are grateful to the Institute of Chartered Financial Analysts.

Much credit is also due to the development and production team: our special thanks goes to Michele Janicek, whose efforts and skill have contributed greatly to this and previous editions; Randall Adams, senior sponsoring editor; Jean Lou Hess, senior project manager; and Jennifer Hollingsworth, designer.

Finally, once again, our most important debts are to Judy, Hava, and Sheryl for their unflagging support.
A Note from the Authors

We wrote the first edition of this textbook 10 years ago. It has been a decade of rapid and profound change in the investments industry. Among the notable developments in financial markets in this period decade are:

• The coming of age of on-line and internet trading, as well as the more recent advent of trading via electronic communication networks
• The rapid and ongoing growth of derivative markets
• The increasing globalization of security markets

Of necessity, our text has evolved along with the financial markets. In this edition, we address many of the changes in the investment environment.

At the same time, many basic principles remain important. We continue to organize our book around one basic theme - that security markets are nearly efficient, meaning that most securities are usually priced appropriately given their risk and return attributes. There are few free lunches found in markets as competitive as the financial market. This simple observation is, nevertheless, remarkably powerful in its implications for the design of investment strategies; and our discussions of strategy are always guided by the implications of the efficient markets hypothesis. While the degree of market efficiency is, and will always be, a matter of debate, we hope our discussions throughout the book convey a good dose of healthy criticism concerning much conventional wisdom.

This text also continues to emphasize asset allocation more than most other books. We prefer this emphasis for two important reasons. First, it corresponds to the procedure that most individuals actually follow when building an investment portfolio. Typically, you start with all of your money in a bank account, only then considering how much to invest in something riskier that might offer a higher expected return. The logical step at this point is to consider other risky asset classes, such as stock, bonds, or real estate. This is an asset allocation decision. Second, in most cases the asset allocation choice is far more important than specific security-selection decisions in determining overall investment performance. Asset allocation is the primary determinant of the risk-return profile of the investment portfolio, and so it deserves primary attention in a study of investment policy.

Our book also focuses on investment analysis, which allows us to present the practical applications of investment theory, and to convey insights of practical value. In this edition of the text, we have introduced a systematic collection of Excel spreadsheets that give students tools to explore concepts more deeply than was previously possible. These spreadsheets are available through the World Wide Web, and provide a taste of the sophisticated analytic tools available to professional investors.

In our efforts to link theory to practice, we also have attempted to make our approach consistent with that of the Institute of Chartered Financial Analysts (ICFA). The ICFA administers an education and certification program to candidates for the title of Chartered Financial Analyst (CFA). The CFA curriculum represents the consensus of a committee of distinguished scholars and practitioners regarding the core of knowledge required by the investment professional.

This text will introduce you to the major issues currently of concern to all investors. It can give you the skills to conduct a sophisticated assessment of current issues and debates covered by both the popular media as well as more specialized finance journals. Whether you plan to become an investment professional, or simply a sophisticated individual investor, you will find these skills essential.

Author Name
Another Name
Lots of people have assets such as social security benefits, pension and group insurance plans, and cravings components of life insurance policies. Yet they exercise limited control, if any on the investment decisions of these plans. The funds that secure pension and life insurance plans are managed by institutional investors.

Outside of the “forced savings” plans however individuals can manage their own investment portfolios. As the populations grows richer more and more people face this decision.

Managing your own portfolio appears to be the lowest cost solution. Conceptually there is little difference between managing one’s own investments and professional financial planning investment if at time we skip details. Our in with allies spirited jargon. If you develop this acquaintance now you should find our later discussions more productive.

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1. The Investment Process: Investor Objectives and Constraints
2. The Investment Process: Strategy and Policies
3. The Financial System and Institutions
There exists an intrinsic connection between the common good.

*Pope John XIII, Roman Catholic Church*
Part 3

Derivative Assets:
Options and Futures

1. The Investment Process: Investor Objectives and Constraints
2. The Investment Process: Strategy and Policies
3. The Financial System and Institutions
Investment strategy for an individual or for an institution involves market timing, asset allocation, and security selection. Investors formulate strategies.

- Managing your own portfolio appears to be the lowest cost solution.
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The first aim of this chapter is to describe how the investment industry relates to investor objectives.

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This is a First Level Head in a Vignette

Lots of people have assets such as social security benefits, pension and group insurance plans, and cravings components of life insurance policies. Yet they exercise limited control, if any on the investment decisions of these plans.

This is a Second Level Head

Outside of the “forced savings” plans however individuals can manage their own investment portfolios. As the populations grows richer more and more people face this decision.

This is a Third Level Head

Outside of the “forced savings” plans however individuals can manage their own investment portfolios.

Source: This is a source line.

1 This is a footnote and it positions at the bottom of the page.
After studying this chapter you should be able to:

1. How the US government helps importers
2. The steps necessary to move goods across country borders.
3. How various import restrictions are used politically.
4. Means of reducing import taxes to remain competitive.
5. The basic instruments for foreign commercial payments.
6. The mechanics of export documents and their importance.

Investment strategy for an individual or for an institution involves market timing, asset allocation, and security selection. Investors formulate strategies according to capital market expectations and investor specific circumstances such as tax obligations. Investment strategy also calls for portfolio monitoring performance evaluation and decisions on portfolio adjustment.

The first aim of this chapter is to describe how the investment industry relates to investor objectives. We present some intuitive arguments that we explain more rigorously in later chapters. Don’t be frustrated if at time we skip details. Our intentions to provide some broad perspective on the investment process with allies spirit dynamism and related jargon. If you develop this acquaintance now you should find our later discussions more productive.

Lots of people have assets such as social security benefits, pension and group insurance plans, and cravings components of life insurance policies. Yet they exercise limited control, if any on the investment decisions of these plans. The funds that secure pension and life insurance plans are managed by institutional investors.

Outside of the “forced savings” plans however individuals can manage their own investment portfolios. As the populations grows richer more and more people face this decision.
Chapter 23

Capital Asset Pricing with a Runover: Subtitle Follows

Chapter Outline
Global Perspective: An Export Sale: From Trade Show to Installation
Export Restriction
  Second Level Head Here
  Another Second Level Head
Import Restrictions
Terms of Sale
Getting Paid: Foreign Commercial Payments
Export Documents
Packing and Marking
Customs-Privileged Facilities
Logistics
The Foreign-Freight Forwarder

Chapter Learning Objectives
What you should learn from Chapter 15
  • How the US government helps importers
  • The steps necessary to move goods across country borders.
  • How various import restrictions are used politically.
  • Means of reducing import taxes to remain competitive.
  • The basic instruments for foreign commercial payments.
  • The mechanics of export documents and their importance.
  • The logistics and problems of the physical movement of goods.
Chapter 23

Capital Asset Pricing: Arbitrage Pricing

There exists an intrinsic connection between the common good.

_Pope John XIII, Roman Catholic Church_

The photo caption on the chapter opener page will position underneath the photo.

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To formalize this notion of a risk penalty system, we will assume that each investor can assign a welfare or utility score to competing investment portfolios according to the expected return and risk of those portfolios. The utility score is a means of ranking portfolios. Hersher utility values are assigned to portfolios with more attractive risk-return profiles. Portfolios receive higher utility scores for higher expected returns and lower scores for higher volatility.

Many scoring systems are legitimate. One reasonable function that is commonly employed by CFRA's and financial theorists assigns a portfolio with expected return $E(r)$ and variance of returns the following utility score:

$$U = E(r) - (1/2)A$$  \hspace{1cm} (7.1)  

where $U$ is the utility value, and $A$ is an index of the investor's aversion to taking on risk. The factor of $1/2$ is a scaling convention that has no economic significance.

This is the mean-standard deviation or equivalently mean-variance (M-V) criterion. It and be stated as investment A dominates investment and at least one inequality is twice.

In the expected return-standard deviation graph, the preferred direction is northwest because in this direction we simultaneously increase the expected return and decrease the standard deviation of the rate of return. This means any portfolio that lies northwest of P is superior to P.

Maximize the number of observations by taking more frequent return readings.

Specify the exact makeup of the portfolio to obtain better estimates of the risk parameters at each observation period.

To determine some of the points that appear on the indifference curve, examine Table 7.1 which gives the utility values of several possible portfolios for an investor with $A = 4$. Each portfolio offers identical utility because the higher return portfolios also have high risk. Although in practice the exact indifference curves of various investors cannot be known, this sort of.

For any degree of risk aversion, investors may be attracted as much as to portfolios with high risk and high expected returns as to other portfolios with lower risk but lower expected returns.

**FIGURE 6.2**

This is a Figure Title

Rates of return of bills, bonds, and stocks, 1926 to 1990.

Source: Cadbury Schweppes p.l.c., September 1984

*Somdett’s after tax profits are given by 0.6(EBIT - $3.2 million).

†Somdett’s equity is only $60 million.
There exists an intrinsic connection between the common good.

*Pope John XIII, Roman Catholic Church*

The presence of risk means more than one outcome is possible. A simple prospect is an investment opportunity in which a certain initial wealth is placed at risk, and there are only two possible outcomes. For the sake of simplicity it is useful to begin our analysis and elucidate some basic concepts using simple prospects.

Take as an example initial wealth, \( W \), of $100,000 and assume two possible results. With a probability of \( p = 0.6 \), the favorable outcome will occur, leading results:

\[
\begin{align*}
W &= 100,000 \\
p &= 0.6 \\
W_1 &= 150,000 \\
1 - p &= 0.4 \\
W_2 &= 80,000
\end{align*}
\]

Suppose an investor, Susan is offered an investment portfolio with a payoff in one year that is described by such a simple prospect. How can she evaluate this portfolio?

1. The expected profit on the $100,000 investment portfolio is $22,000: 122,000 - 100,000. The variance, \( \sigma^2 \), of the portfolio payoff is calculated as the expected value of the squared deviations of each possible outcome from the mean.

2. The standard deviation, \( \sigma \), which is the square root of the variance is $34,292.86. Clearly, this is risky business. The standard deviation of the payoff is larger, much larger than the expected profit of $22,000. Whether the expected profit is larger than the expected enough to justify such risk depends on the alternative portfolios.

**Risk, Speculation, and Gambling**

Speculators assume risk voluntarily and are often confused with gamblers who also seek risk. The business of investors is speculation so it is well to start by distinguishing them from gamblers.

One dictionary’s definition of speculation is the assumption of considerable business risk in obtaining commensurate gain. While this definition is fine linguistically it is vague if we cannot specify what is meant by considerable risk an commensurate gain process consists broadly speaking of tow tasks. One is security and market analysis, by which we assess the risk and expected return of the entire set of available investment vehicles. The second is construction of the optimal portfolio of assets where we identify the set of efficient portfolios those with the best risk return characteristics. The second is construction of the optimal portfolio of assets optimal portfolio of assets where we identify the set of efficient portfolios those with this is the
The desirability of portfolios in quadrants II and III compared with P depends on the investor’s risk aversion. Starting at P an increase in standard deviation lowers utility it must be offset by an adequate increase in expected return. Thus point Q in Figure 7.1 represents a portfolio that is a desirable to this investor as portfolio P.

To determine some of the points that appear on the indifference curve examine Table 7.1 which gives the utility values of several possible portfolios for and investor with \( A = 4 \). Each portfolio offers identical utility because the higher return portfolios also have high risk. Although in practice the exact indifference curves of various investors cannot be known, this sort of approach and take us along way in determining appropriate principles for portfolio selection strategy.

What is the risk premium of Susan’s risky portfolio in terms of rate of return rather than dollars? What is the standard deviation of the rate of return?

1. What is the risk premium of Susan’s risky portfolio in terms of rate of return rather than dollars?
2. What is the standard deviation of the rate of return?

### Concept Check

#### 1.3 Numbered First Level Head One Risky Asset and One Risk-Free Asset

**The Risk Asset**

Now we can talk about combining assets. We start by considering investors holding a risky portfolio called P, along with some money market securities such as T-bills which we will refer to as the risk free asset F.

When we shift wealth form the risky portfolio (P) to the risk free asset we do no change the relative proportions of the various risky portfolio as a whole in favor of risk free assets. Rather we reduce the relative weight of the risky portfolio as a whole in favor of risk free assets.

**This is a List Lead and All List Heads Look the Same**

- The security market line
- The put call parity relationship
- The Black-Scholes option pricing model

<table>
<thead>
<tr>
<th>Scenario</th>
<th>EBIT ($ millions)</th>
<th>Net Profits ($ millions)</th>
<th>ROE (%)</th>
<th>Net Profits ($ millions)</th>
<th>ROE (%)</th>
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<tr>
<td>Bad year</td>
<td>5</td>
<td>3</td>
<td>3</td>
<td>1.08</td>
<td>1.8</td>
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<tr>
<td>Normal year</td>
<td>10</td>
<td>6</td>
<td>6</td>
<td>4.08</td>
<td>6.8</td>
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<tr>
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</table>

*Somdett’s after tax profits are given by \( .6(EBIT - $3.2 million) \).
*Somdett’s equity is only $60 million.
MARKETING EFFORTS TARGET INDIVIDUALS

New York—Just as money-market funds were the hot product in 1989, so stock index funds are quickly becoming the scene of this year’s biggest mutual fund marketing battle.

Following the stellar performance of Vanguard Group’s index funds both Dreyfus Corp and Fidelity Investments have weighted in with index funds of their own. In recent weeks both funds groups have come out with unmanaged portfolios of the stocks that make up the Standard & Poor’s 500 stock index; these funds are designed to closely track the S & P 500’s performance.

Investors are just waking up to the virtues of index investments which have already attracted about $250 billion from giant institutions. The oldest and largest of the index mutual funds, Vanguard Index Trust 500.

As reported here earlier this year the investment success of Vanguard’s index funds was long ignored by Vanguard’s competitors. Not any more. Both Dreyfus and Fidelity are now running full page advertisements as they seek to wrestle a share of the index fund business away from Vanguard.

Marginal Product

As far as a mutual fund manager is concerned an index fund is a magical product says on analyst. It already has a performance record that of the index.

For years Vanguard has had a virtual strangle hold on the index fund market.

It offers index funds that track a bond market index tow international stock indexes and tow small company stock indexes.

If Dreyfus and Fidelity thought that this year’s index funds would match the popularity of last year’s money market funds they have clearly been disappointed. Early in 1989 both Dreyfus and Fidelity brought out low cost money market funds jumping into an area previously simulated buy Vanguard. Dryfuss world wide dollar Fund has since pulled in $7.3 billion. Fidelity Spartan Money Market Fund has snagged 8.3 billion. Fidelity Spartan Money Market Fund has snagge. Standard & Poor’s 500 stock index; these funds are designed to closely track the S & P 500’s performance.

EDUCATION PROBLEM

They are jumping onto the index fund band wagon and they’re trying to get some attention by waiving the fees says John Bogle Vanguard’s chairman Fees are the only thing that distinguishes one money market fund from another #When you get to and index fund fees are just one of the things that affect return. Only a moron would buy a stock fund to avoids a 0.5 percent expenses ratio for two weeks or tow months. Apparently the marketplace is smarter than the fund sponsors.

1. To complete both Dreyfus and Fidelity are holding down expenses on their index funds.
2. Dreyfus is adsorbing all expenses until the line oft thy year or until the fund hits $100 million in assets which ever comes first. Fidelity has promised to keep its expenses at 0.28 percent of assets until May 1, 1991. If Dreyfus and Fidelity thought that this year’s index funds would match the popularity of last year’s money market funds they have clearly been disappointed.


1 Reprinted by permission of THE WALL STREET JOURNAL.
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2. Specify the exact makeup of the portfolio to obtain better estimates of the risk parameters at each observation period.

**Front-End Load** A front-end load is a commission or sales charge paid when you purchase the shares. These charges typically fall between 4 percent and 8.5 percent and are used to pay brokers to sell the fund.
To be listed on NASDAQ a firm must satisfy one of two sets of criteria:

1. **a.** 350,000 publicly held shares.
   
   **b.** Market value of publicly held shares of $2 million.
   
   **c.** Minimums bid price of $3.
   
   **d.** Annual net income of $300,000 in either the last fiscal year or two of the last three years.

   or

2. **a.** 800,000 publicly held shares.
   
   **b.** Market value of publicly held shares of $8 million.
   
   **c.** Net worth of $8 million.
   
   **d.** Incorporation of at least 4 years.

NASDAQ has three levels of subscribers. The highest level 3 subscribers are for firms dealing or making markets in OTC securities. These market makers maintain inventories of a security and constantly stand ready to buy or sell these shares from or to the public at the quoted bid and ask price.

<table>
<thead>
<tr>
<th>(b) Nov. 12</th>
<th>Accounts Payable</th>
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<td>(2% 3 $1,200)</td>
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<td>24</td>
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<tr>
<td></td>
<td>paid for the purchase of November 2 less the discount.</td>
<td></td>
<td></td>
<td>1,176</td>
</tr>
</tbody>
</table>

This is a First Level Head in Display font Bauer Bodoni

The capital allocation line is derived with the risk free asset and the risky portfolio P. Investors can determine the assets to be included in the risky portfolio using either a passive or an active strategy. A passive strategy describes an investment decision that avoids any security would appear to be naive yet the efficient market hypothesis predicts that forces of supply.

**EXERCISE 18.32**

*Put-call Parity; Subtitle*

Suppose you confront the following data for a certain stock. This result a violation of parity (12 does not equal 10) indicates mispricing and leads to an arbitrage opportunity. You can by the relatively cheap portfolio the stock pulls borrowing position represented on the right hand side of the equation and sell the relatively expensive portfolio! The long call short put position corresponding to the left hand side that is write a call and We use these data in the put-call parity theorem to see if parity is violated.

\[
E(W) = pW_1 + (1 - p)W_2
\]

\[
= [.6 \times 150,000] + [.4 \times 80,000] = $122,000
\]

This result a violation of parity (12 does not eaual 10) indicates mispricing and leads to an arbitrage opportunity.

This is an Example Head

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The long call short put position corresponding to the left hand side that is write a call and buy a put.

1. Let’s examine the payoff to this strategy. In six months the stock will be worth $St. The $100 borrowed will be paid back with interest resulting in a cash flow of $105. The written call will revert in a cash outflow of $St if the stock price is below $105.

Table 15.1 summarizes the outcome. The immediate cash inflow is $2. In six months the various positions provide exactly offsetting cash flow: the $2 inflow is realized relessly without any offsetting outflow.

The firm is willing to make only limited bets on interest rate movements. As Francis Tranier puts it in his speech:

If we set saturation of our portfolios at a level equal to the index and never allow them to vary this would imply that we are perpetually neutral on the direction of interest rate. However as those of you who have followed our economic forecasts are aware this is rarely the case.

The expected profit on the $100,000 investment portfolio is $22,000: $122,000 - $100,000. The variance, $\sigma^2$, of the portfolio payoff is calculated as the expected value of the squared deviations of each possible outcome from the mean. The standard deviation, $\sigma$, which is the square root of the variance is $34,292.86$.

### A Basic Decomposition: The Risky Portfolio and the Safe Asset

Clearly, this is risky business. The standard deviation of the payoff is larger, much larger than the expected profit of $22,000. Whether the expected profit is larger than the expected enough to justify such risk depends on the alternative portfolios.

This is an Extract Title

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Suppose Treasury bills are one alternative to Susan’s risky portfolio and that at the time of the decision a one year T-bill offers a rate of return of 5 percent; $100,000 and be invested to yield a such profit of $5,000. The question of whether a given risk premium provides adequate compensation for the investment’s risk is age-old. If you have absorbed all the lessons of this book, you know the lesson: risk.

<table>
<thead>
<tr>
<th>Merchandise Inventory</th>
<th>Accounts Payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nov. 2 1,200</td>
<td>Nov. 12 1,200</td>
</tr>
<tr>
<td>Balance 1,176</td>
<td>Balance 0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Value of portfolio A</th>
<th>Value of portfolio B</th>
<th>Value of portfolio C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$14,000</td>
<td>0</td>
<td>14,688</td>
</tr>
<tr>
<td>$16,000</td>
<td>0</td>
<td>14,688</td>
</tr>
<tr>
<td>$18,000</td>
<td>10,000</td>
<td>16,688</td>
</tr>
<tr>
<td>$20,000</td>
<td>20,000</td>
<td>18,688</td>
</tr>
<tr>
<td>$22,000</td>
<td>30,000</td>
<td>20,688</td>
</tr>
</tbody>
</table>
SPREADSHEET MODEL FOR CALCULATION OF DURATION

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Questions
1. Many observation are needed to dray significant conclusion even whom portfo-
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2. Shifting parameters when portfolios are actively managed made accurate perform-
ance evaluation all the more elusive.

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Lots of people have assets such as social security benefits, pension and group insurance plans, and cravings components of life insurance policies. Yet they exercise limited control, if any on the investment decisions of these plans. The funds that secure pension and life insurance plans are managed by institutional investors.
When we shift wealth form the risky portfolio (P) to the risk free asset we do no change the relative proportions of the various risky portfolio as a whole in favor of risk free assets. Rather we reduce the relative weight of the risky portfolio as a whole in favor of risk free assets.

A. The security market line
B. The put call parity relationship
C. The Black-Scholes option pricing model

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Person A: The security market line
Person B: When we shift wealth form the risky portfolio (P) to the risk free asset we do no change the relative proportions of the various risky portfolio as a whole in favor of risk free assets. Rather we reduce the relative weight of the risky portfolio as a whole in favor of risk free assets.

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Poetry should be set line for line and the longest line is centered within the text.

When he has spent many years in captivity and a runover in the verse.

—Poetry Author, Affiliation

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Finally extension of the multifactor SML of Equation 7.3 to individual asset is precisely the same for the one factor APT. Equation 7.3 cannot be satisfied by every well diversified portfolio unless it is satisfied by virtually every security taken individually.

The generalized APT must be qualified with respect to individual assets just as in the single factor case. A multifactor CAPM would at the cost of the additional assumption on investor mean variance efficiency apply to any and all individual assets. As we have seen the result will be a security market evaluation that is identical to the one of the multifactor APT and SML.

---

**Reading/Case 1-3**

**Reading/Case Title in Bauer Bodoni: The Subtitle Runs In**

**Author Name, Affiliation**

Managing your own portfolio appears to be the lowest cost solution. Conceptually there is little difference between managing one’s own investments and professional financial planning investment if at time we skip details.

**Investment Strategy and Policies**

**Manage Your Own Portfolio or Rely on Others?**

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**Risk, Speculation, and Gambling**

Speculators assume risk voluntarily and are often confused with gamblers who also seek risk. The business of investors is speculation so it is well to start by distinguishing them from gamblers. One dictionary’s definition of speculation is the assumption of considerable business risk in obtaining commensurate gain.

**This is a Third Level Head**

While this definition is fine linguistically it is vague if we cannot specify what is meant by considerable risk an commensurate gain process consists broadly speaking of tow tasks. One is security and market analysis, by which we assess the risk and expected return of the entire set of available investment vehicles. The second
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**Reading/Case 1-3**

**Reading/Case Title in Stone Sans: The Subtitle**

**Runs-In and May Runover**

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Part Three  Fixed-Income Securities

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Appendix 1

Chapter Appendix Title in Stone Sans: The Subtitle Runs-In

Author Name, Affiliation

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### Summary

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- One approach to firm valuation is to focus on the forms’ book value either as it appears as it appears on the balance sellt or as adfuted to reflect current rep;acement cost of assets or liwuidation value. Another approach is to focus on the present value of expected future dividendts.
- The constant growth vesion of the DDM asserts that if dividends are expected to frow at a constant rate forever, then the intrinsic value of athe stock is dertimined by the formual
  \[
  V_0 = \frac{D_1}{k - g}
  \]
  There are more sophisticated multistage versions of the model for more comples environments. When the constant growth assumption is reasonabley satisfied the formaul can be inverted to infer the market capitalization rate for the stock.
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### Key Terms

- book value, 446
- constant growth DDM, 420
- discounted dividend model, 419
- dividend payout ratio, 422
- earnings retention ratio, 422
- fundamental analysts, 415
- intrinscis value, 416
- liquidation value, 416
- market capitalization rate, 418
- plowback ratio, 422
- price/earnings multiple, 428
- replacement cost, 416
- technical analysts, 425
- Tobin’s 416
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A search engine for finance related sites is provided at:

www.financewise.com

1. a. Computer stocks currently provide an expected rate of return of 16 percent. MBI, a large computer company will pay a year end dividend of $2 per share. If the stock is selling at $50 per share what must be the market’s expectation of the growth rate of MBI dividends?

b. If dividend growth forecasts for MBI are revised downward to 5 percent per year what will happen to the price of MBI stock? What will happen to the company’s price earnings ratio?

2. The constant growth dividend discount model can be used both for the valuation of companies and for the estimation of the long-term total return of a stock.

3. If the expected rate of return of the market portfolio is 15 percent and a stock with a beta of 1.0 pays a dividend yield of 4 percent, what must the market believe is the expected rate of price appreciation on that stock?

4. The risk free rate of return is 10 percent the required rate of return on the market is 15 percent and High Flyer stock has a beta coefficient of 1.5. If the dividend per share expected during the coming year D is $2.50 and g = 5 percent at what price should a share sell?

**Problem Sets**

The generalized APT must be qualified with respect to individual assets just as in the single factor case.

**Solutions to Concept Check**

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1. Maximize the number of observations by taking more frequent return readings.
2. Specify the exact makeup of the portfolio to obtain better estimates of the risk parameters at each observation period.

In the presence of window dressing even the reported quarterly composition data can be misleading. Mutual funds publish portfolio value on a daily basis, which means the rate of return of each day is publicly available, but portfolio composition is not.

One important factor affecting mutual fund performance is the fee structure. You should be aware of four general classes of fees.

**Front-End Load** A front-end load is a commission or sales charge paid when you purchase the shares. These charges typically fall between 4 percent and 8.5 percent and are used to pay brokers to sell the fund. Low-load funds have loads that range from 1 percent of 3 percent of invested funds. Low-load funds have loads that range from 1 percent
abnormal return  Rures conubium santet. (45)

word  Saetosus cathedras satis spinosus circumgrediet vix tremulus catelli, iam adfabilis saburre iocari saetosus catelli, etiam chirographi deciperet catelli, utcunque fiducia suis divinus fermentet agricolae, quamquam gulosus quadrupei deciperet perspicax ossifragi. (82)
word  Quinquennalis concubine vocificat pretosius syrtes, iam verecundus chirographi deciperet Octavius, quamquam ossifragi conubium santet Medusa, semper oratori comiter suffragarit Aquae Sulis, quod umbraculi circumgrediet pessimus saetosus chirographi.

word  Plane verecundus rures senesceret aegre utilitas catelli, etiam saburre verecundiet circumgrediet Medusa. Lascivius fiducia suis iocari Augustus.

word  Saetosus cathedras suffragarit Caesar.

word  Satis bellus ossifragi comiter miscere concubine, quod Augustus senesceret catelli


ABC, 60
Account management of advertising firm, 319
Accuracy of news, 37–376
Acquisition editor, 119
Acta diurna, 125
Administration (department)
  in advertising firm, 319
  in magazine publishing, 172
  in music department, 256
  in television, 287
Advertiser(s)
  public relations for, 396
  top 10, 303
  Advertiser influence, 392–396
  Advertising 294–296
    A-T-R model and, 302–303
    bandwagon and, 307
    card stacking and, 307
    of cigarettes, 31
    consumers’ information environment and 303–304
    controversies about, 308–310
    cutting-edge theory and, 31–302
    development of, 296–298, 300
      early, 296
    eight lifestyles and, 317
    electronic, 297–298, 300
    expanding world of, 301
    first ad agency and, 296, 297
    future of, 319–320
    government regulation of, 297
    of hard liquor, 314
    in magazines, 173
    minimal-effects theory and, 300–301
    mission of VALS and, 317
    music and, 307–308