

Contents

Preface	xv
Acknowledgments	xix
About the Author	xxiii
CHAPTER 1	
Overview of Investment Management	1
Setting Investment Objectives	2
Establishing an Investment Policy	4
Selecting a Portfolio Strategy	9
Constructing and Monitoring the Portfolio	10
Measuring and Evaluating Performance	11
References	11
PART ONE	
Portfolio Theory and Asset Pricing	13
CHAPTER 2	
Theory of Portfolio Selection	15
Some Basic Concepts	16
Measuring a Portfolio's Expected Return	19
Measuring Portfolio Risk	21
Portfolio Diversification	26
Choosing a Portfolio of Risky Assets	30
Index Model's Approximations to the Covariance Structure	36
Summary	39
References	40

CHAPTER 3		
Applying Mean-Variance Analysis		41
Using Historical Data to Estimate Inputs		42
Application of Portfolio Theory to Asset Allocation		46
Implementing the Optimal Portfolio		53
Summary		56
References		57
CHAPTER 4		
Issues in the Theory of Portfolio Selection		59
Quick Review of Probability Theory		60
Limitations of the Variance as a Risk Measure		64
Desirable Features of Investment Risk Measures		68
Alternative Risk Measures for Portfolio Selection		74
Extensions of the Theory of Portfolio Selection		77
Behavioral Finance Attack on the Theory of Portfolio		80
Summary		82
References		84
CHAPTER 5		
Asset Pricing Theories		89
Characteristics of an Asset Pricing Model		90
Capital Asset Pricing Model		91
Arbitrage Pricing Theory Model		102
Some Principles to Take Away		107
Summary		108
Appendix		109
References		117
PART TWO		
Common Stock Analysis and Portfolio Management		119
CHAPTER 6		
The U.S. Equity Markets		121
Exchange Market Structures		121
The U.S. Stock Markets: Exchanges and OTC Markets		125
Off-Exchange Markets and Alternative Electronic Markets		134
Evolving Stock Market Practices		138
Basic Functioning of Stock Markets		140

Summary	145
References	145
CHAPTER 7	
Common Stock Strategies and Performance Evaluation	147
Market Efficiency	147
Stock Market Indicators	149
Top-Down vs. Bottom-Up Approaches	152
Fundamental vs. Technical Analysis	153
Strategies Based on Technical Analysis	154
Strategies Based on Fundamental Analysis	161
Equity Style Investing	166
Passive Strategies	169
Measuring and Evaluating Performance	176
Summary	187
References	189
CHAPTER 8	
Financial Analysis	193
Financial Ratio Analysis	194
Cash Flow Analysis	223
Usefulness of Cash Flows in Financial Analysis	235
Summary	241
References	242
CHAPTER 9	
Applied Equity Valuation	245
Discounted Cash Flow Models	245
Relative Valuation Methods	266
DCF vs. RV Methods	272
Summary	275
References	276
CHAPTER 10	
Forecasting Stock Returns	277
The Concept of Predictability	279
A Closer Look at Pricing Models	286
Predictive Return Models	287
Is Forecasting Markets Worth the Effort?	293
Summary	295
References	297

CHAPTER 11**Managing a Common Stock Portfolio with Fundamental Factor Models 299**

Tracking Error	300
Fundamental Factor Model Description and Estimation	309
Risk Decomposition	312
Applications in Portfolio Construction and Risk Control	316
Summary	329
References	330

CHAPTER 12**Transaction Costs and Trade Execution in
Common Stock Portfolio Management 331**

Trading Mechanics	332
Trading Arrangements for Institutional Investors	335
A Taxonomy of Transaction Costs	340
Liquidity and Transaction Costs	347
Market Impact Measurements and Empirical Findings	349
Forecasting and Modeling Market Impact	352
Incorporating Transaction Costs in Asset-Allocation Models	355
Optimal Trading	356
Integrated Portfolio Management	
Beyond Expected Return and Portfolio Risk	359
Summary	360
References	362

CHAPTER 13**Using Stock Index Futures and Equity Swaps in
Equity Portfolio Management 365**

Derivatives Process	366
Basic Features of Futures Contracts	367
Basic Features of Stock Index Futures	373
Applications for Stock Index Futures	381
Equity Swaps	393
Summary	394
References	395

CHAPTER 14**Using Equity Options in Investment Management 397**

Basic Features of Options	397
Basic Features of Listed Equity Options	400
Risk and Return Characteristics of Listed Options	402

The Option Price	410
Use of Listed Equity Options in Portfolio Management	415
OTC Equity Options: The Basics	421
Use of Exotic Equity Options	425
Summary	426
References	427
CHAPTER 15	
Equity Option Pricing Models	429
Put-Call Parity Relationship	429
Option Pricing Models	431
Sensitivity of the Option Price to a Change in Factors	447
Estimating Expected Stock Return Volatility	452
Summary	453
References	454
PART THREE	
Bond Analysis and Portfolio Management	455
CHAPTER 16	
Bond Fundamentals and Risks	457
Features of Bonds	457
Risks Associated with Investing in Bonds	467
Summary	482
Appendix: Calculating Accrued Interest	484
References	486
CHAPTER 17	
Treasury and Agency Securities, Corporate Bonds, and Municipal Bonds	487
Treasury Securities	487
Federal Agency Securities	490
Corporate Bonds	491
Municipal Bonds	495
Non-U.S. Bonds	501
Summary	504
References	505

CHAPTER 18	
Structured Products: RMBS, CMBS, and ABS	507
Agency Residential Mortgage-Backed Securities	509
Private-Label Residential MBS	528
Mortgage-Related, Asset-Backed Securities: Subprime MBS	533
Commercial Mortgage-Backed Securities	537
Nonmortgage Asset-Backed Securities	540
Summary	546
References	547
CHAPTER 19	
The Structure of Interest Rates	549
The Base Interest Rate	549
The Risk Premium Between Non-Treasury and Treasury Securities with the Same Maturity	550
Factors Affecting the Risk Premium	551
Term Structure of Interest Rates	555
Summary	564
References	565
CHAPTER 20	
Bond Pricing and Yield Measures	567
Pricing of Option-Free Bonds	567
Conventional Yield Measures	576
Portfolio Yield Measures	583
Total Return	585
Summary	592
CHAPTER 21	
Bond Price Volatility and the Measurement of Interest Rate Risk	593
Price Volatility Properties of Option-Free Bonds	593
Factors that Affect a Bond's Price Volatility	596
Measuring Interest Rate Risk Using the Price Value of a Basis Point	596
Measuring Interest Rate Risk Using Duration and Convexity	598
Measuring Exposure to Yield Curve Changes Key Rate Duration	610
Summary	611
References	612

CHAPTER 22	
Valuing Bonds with Embedded Options	613
The Interest Rate Lattice	614
Calibrating the Lattice	618
Using the Lattice for Valuation	622
Using the Lattice Model to Value Bonds with Embedded Options	625
Extensions	630
Summary	634
References	634
CHAPTER 23	
Bond Portfolio Strategies	635
Bond Market Indexes	635
The Spectrum of Strategies	640
Value-Added Strategies	647
Using Factor Models to Manage a Portfolio	658
Liability-Driven Strategies	672
Summary	680
References	682
CHAPTER 24	
Using Derivatives in Bond Portfolio Management	683
Using Treasury Bond and Note Futures Contracts in Bond Portfolio Management	683
Use of Interest Rate Options in Bond Portfolio Management	692
Using Interest Rate Swaps in Bond Portfolio Management	704
Using Stock Index Futures and Treasury Bond Futures to Implement an Asset Allocation Decision	715
Using Credit Default Swaps to Manage Credit Risk	716
Summary	720
References	722

PART FOUR**Investment Companies, Exchange-Traded Funds,
and Alternative Investments 723****CHAPTER 25****Investment Companies, Exchange-Traded Funds,
and Investment-Oriented Life Insurance 725**

Investment Companies	725
Exchange-Traded Funds	739
Investment-Oriented Life Insurance	744
Summary	764
References	765

CHAPTER 26**Alternative Assets 767**

Hedge Funds	767
Private Equity	786
Commodity Investments	798
Summary	806
References	807

APPENDIX**Measuring and Forecasting Yield Volatility 809**

Calculating the Standard Deviation from Historical Data	809
Modeling and Forecasting Yield Volatility	814
Summary	825
References	825

Index 827