

Contents

Preface	xiii
About the Authors	xv
PART ONE	
Background	1
CHAPTER 1	
What Is Finance?	3
Capital Markets and Capital Market Theory	4
Financial Management	5
Investment Management	7
Summary	8
CHAPTER 2	
Mathematics of Finance	11
The Importance of the Time Value of Money	11
Determining the Future Value	13
Determining the Present Value	20
Determining the Unknown Interest Rate	22
Determining the Number of Compounding Periods	23
The Time Value of a Series of Cash Flows	24
Valuing Cash Flows with Different Time Patterns	34
Loan Amortization	40
The Calculation of Interest Rates and Yields	46
Principles of Valuation	51
Summary	55
CHAPTER 3	
Basics of Financial Analysis	57
Financial Ratio Analysis	58
Cash Flow Analysis	87

Usefulness of Cash Flows in Financial Analysis	99
Summary	105

PART TWO

Capital Markets and Capital Market Theory 109

CHAPTER 4

The Financial System 111

Financial Assets/Financial Instruments	111
Financial Markets	113
Financial Intermediaries	114
Regulators of Financial Activities	118
Classification of Financial Markets	122
Market Participants	131
Summary	150
References	154

CHAPTER 5

Interest Rate Determination and the Structure of Interest Rates 155

Theories About Interest Rate Determination	155
The Federal Reserve System and the Determination of Interest Rates	157
The Structure of Interest Rates	163
Term Structure of Interest Rates	168
Summary	178
References	179

CHAPTER 6

Basics of Derivatives 181

Futures and Forward Contracts	181
Options	194
Swaps	206
Cap and Floor Agreements	209
Summary	211
Appendix: Black-Scholes Option Pricing Model	212
References	219

CHAPTER 7**Asset Valuation: Basic Bond and Stock Valuation Models 221**

Valuing Bonds	221
Valuation of Common Stock Using Dividend Discount Models	235
Summary	246
Appendix: Valuing Convertible Bonds	247
References	252

CHAPTER 8**Asset Valuation: The Theory of Asset Pricing 255**

Characteristics of an Asset Pricing Model	255
Capital Asset Pricing Model	256
Arbitrage Pricing Theory Model	270
Summary	279
References	281

PART THREE**Financial Management 283****CHAPTER 9****Financial Management 285**

Forms of Business Enterprise	286
The Objective of Financial Management	291
The Agency Relationship	296
Dividend and Dividend Policies	302
Special Considerations in International Financial Management	314
Summary	322
References	325

CHAPTER 10**Financial Strategy and Financial Planning 327**

Strategy and Value	328
Financial Planning and Budgeting	331
Importance of Financial Planning	332
Budgeting Process	332
Sales Forecasting	334

Seasonal Considerations	337
Budgeting	338
Pro Forma Financial Statements	346
Long-Term Financial Planning	352
Financial Modeling	355
Performance Evaluation	362
Strategy and Value Creation	369
Summary	372
References	373

CHAPTER 11

The Corporate Financing Decision 375

Debt vs. Equity	375
The concept of leverage	378
Capital Structure and Financial Leverage	381
Financial Leverage and Risk	384
Capital Structure and Taxes	388
Capital Structure and Financial Distress	393
The Cost of Capital	397
The Agency Relationship and Capital Structure	399
Optimal Capital Structure: Theory and Practice	400
A Capital Structure Prescription	403
Summary	404
Appendix: Capital structure: Lessons from Modigliani and Miller	405
References	415

CHAPTER 12

Financial Engineering, Asset Securitization, and Project Financing 417

Creation of Structured Notes	419
Asset Securitization	427
Project Financing	438
Summary	446
References	448

CHAPTER 13

Capital Budgeting: Process and Cash Flow Estimation 449

Investment Decisions and Owners' Wealth Maximization	450
Capital Budgeting Process	452
Classifying Investment Projects	454

Estimating Cash Flows of Capital Budgeting Projects	458
Summary	477
References	477

CHAPTER 14**Capital Budgeting Techniques 479**

Evaluation Techniques	479
Net Present Value	481
Profitability Index	485
Internal Rate of Return	487
Modified Internal Rate of Return	491
Payback Period	495
Discounted Payback Period	496
Issues in Capital Budgeting	497
Comparing Techniques	500
Capital Budgeting Techniques in Practice	503
Capital Budgeting and the Justification of New Technology	504
Incorporating Risk into Capital Budgeting Analysis	506
Summary	523
References	524

CHAPTER 15**Managing Current Assets 525**

Management of Cash and Marketable Securities	526
Cash Management	527
Marketable Securities	533
Management of Accounts Receivable	534
Inventory Management	545
Summary	553
References	554

CHAPTER 16**Financial Risk Management 555**

Risk Defined	555
Enterprise Risk Management	558
Managing Risks	563
Risk Transfer	565
Summary	572
References	574

PART FOUR**Investment Management 575****CHAPTER 17****The Basic Principles of Investment Management 577**

The Investment Management Process	577
The Theory of Portfolio Selection	582
Tracking Error	604
Measuring and Evaluating Performance	607
Summary	622
References	624

CHAPTER 18**Equity Portfolio Management 625**

Stock Market Indicators	625
Top-Down vs. Bottom-up Approaches	629
Fundamental vs. Technical Analysis	629
Popular Stock Market Strategies	631
Passive Strategies	643
Equity-Style Management	643
Types of Stock Market Structures	646
The U.S. Stock Markets: Exchanges and OTC Markets	649
Trading Mechanics	656
Summary	664
References	665

CHAPTER 19**Bond Portfolio Management 669**

Sectors of the Bond Market	669
Features of Bonds	679
Yield Measures	686
Risks Associated with Investing in Bonds	693
Measuring Interest Rate Risk	702
Bond Indexes	710
Active Bond Portfolio Strategies	711
Passive Bond Portfolio Strategies	716
Summary	719
References	720

CHAPTER 20**Use of Stock Index Futures and Treasury Futures Contracts in Portfolio Management 721**

Using Stock Index Futures in Equity Portfolio Management 722

Using Treasury Bond and Note Futures Contracts in Bond Portfolio Management 736

Using Stock Index Futures and Treasury Bond Futures to Implement an Asset Allocation Decision 744

Summary 746

References 746

CHAPTER 21**Use of Options in Portfolio Management 747**

Using Stock Options and Index Options in Equity Portfolio Management 747

Using Interest Rate Options in Bond Portfolio Management 761

Summary 771

Appendix: Pricing Models on Options on Physicals and Futures Options 771

References 773

Index 775

<http://www.pbookshop.com>