

fundamentals of
INVESTMENTS

Valuation and Management

seventh edition

BRADFORD D. JORDAN | THOMAS W. MILLER JR. | STEVEN D. DOLVIN

Seventh Edition

Fundamentals of Investments

VALUATION AND MANAGEMENT

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FUNDAMENTALS OF INVESTMENTS: VALUATION AND MANAGEMENT, SEVENTH EDITION

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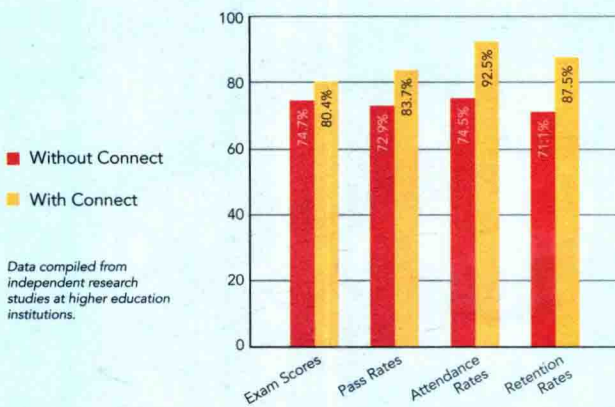
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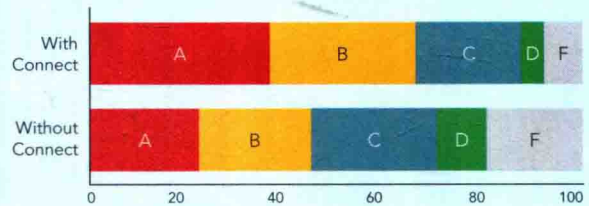
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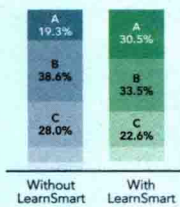


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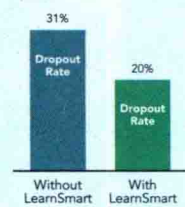
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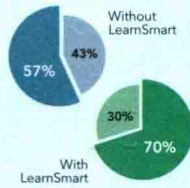
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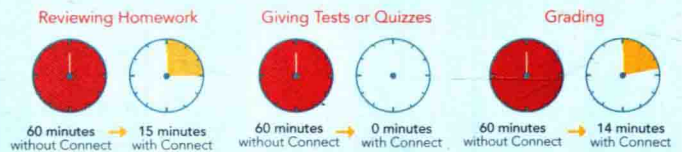
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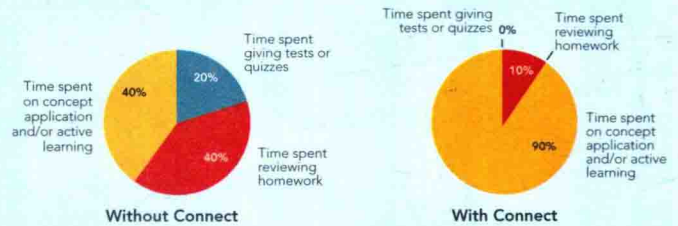


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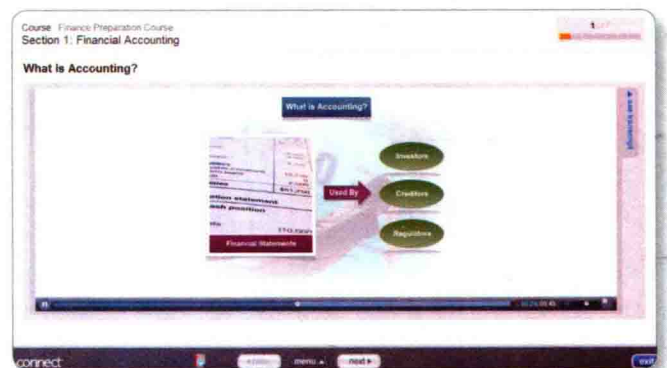


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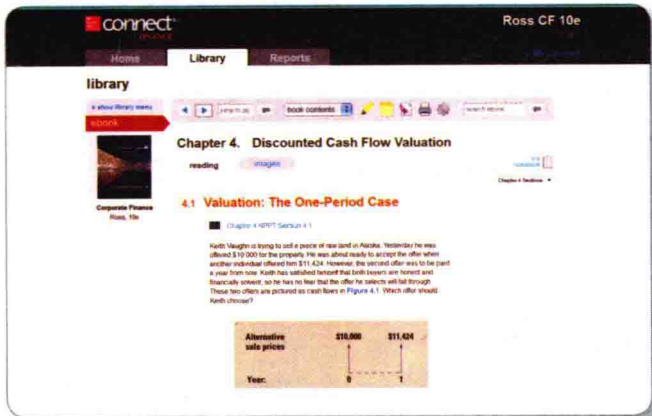
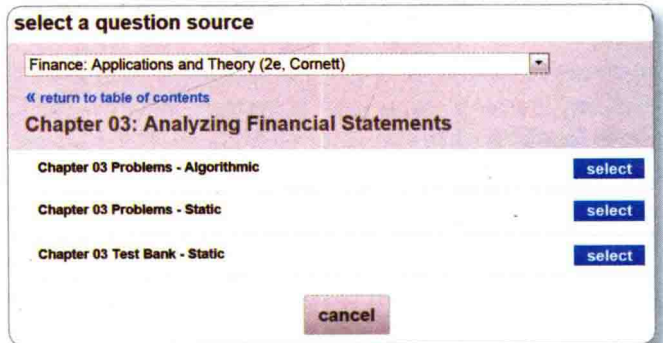




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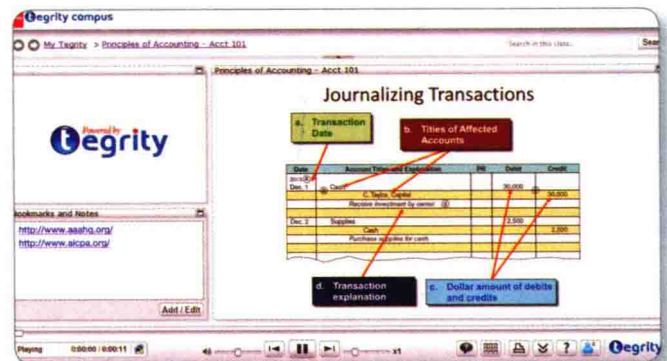


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Fundamentals of Investments

VALUATION AND MANAGEMENT



The McGraw-Hill/Irwin Series in Finance, Insurance, and Real Estate

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Personal Finance: Building Your Future
First Edition

To my late father, S. Kelly Jordan Sr.,
a great stock picker.

BDJ

To my parents, Tom and Kathy Miller,
my wife Carolyn, and #21 —Thomas W. Miller III.

TWM Jr.

To my wife, Kourtney, and the “three L’s”—my greatest
investment in this life.

SDD

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Bradford D. Jordan is Professor of Finance and holder of the Richard W. and Janis H. Furst Endowed Chair in Finance at the University of Kentucky. He has a long-standing interest in both applied and theoretical issues in investments, and he has extensive experience teaching all levels of investments. Professor Jordan has published numerous research articles on issues such as valuation of fixed-income securities, tax effects in investments analysis, the behavior of security prices, IPO valuation, and pricing of exotic options. He is co-author of *Fundamentals of Corporate Finance* and *Essentials of Corporate Finance*, two of the most widely used finance textbooks in the world.

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Preface

So why *did* we write this book?

As we toiled away, we asked ourselves this question many times, and the answer was always the same: *Our students made us.*

Traditionally, investments textbooks tend to fall into one of two camps. The first type has a greater focus on portfolio management and covers a significant amount of portfolio theory. The second type is more concerned with security analysis and generally contains fairly detailed coverage of fundamental analysis as a tool for equity valuation. Today, most texts try to cover all the bases by including some chapters drawn from one camp and some from another.

The result of trying to cover everything is either a very long book or one that forces the instructor to bounce back and forth between chapters. This frequently leads to a noticeable lack of consistency in treatment. Different chapters have completely different approaches: Some are computational, some are theoretical, and some are descriptive. Some do macroeconomic forecasting, some do mean-variance portfolio theory and beta estimation, and some do financial statements analysis. Options and futures are often essentially tacked on the back to round out this disconnected assortment.

The goal of these books is different from the goal of our students. Our students told us they come into an investments course wanting to learn how to make investment decisions. As time went by, we found ourselves supplying more and more supplemental materials to the texts we were using and constantly varying chapter sequences while chasing this elusive goal. We finally came to realize that the financial world had changed tremendously, and investments textbooks had fallen far behind in content and relevance.

What we really wanted, and what our students really needed, was a book that would do several key things:

- Focus on the students as investment managers by giving them information they can act on instead of concentrating on theories and research without the proper context.
- Offer strong, consistent pedagogy, including a balanced, unified treatment of the main types of financial investments as mirrored in the investment world.
- Organize topics in a way that would make them easy to apply—whether to a portfolio simulation or to real life—and support these topics with hands-on activities.

We made these three goals the guiding principles in writing this book. The next several sections explain our approach to each and why we think they are so important.

Who Is This Book For?

This book is aimed at introductory investments classes with students who have relatively little familiarity with investments. A typical student may have taken a principles of finance class and had some exposure to stocks and bonds, but not much beyond the basics. The introductory investments class is often a required course for finance majors, but students from other areas often take it as an elective. One fact of which we are acutely aware is that this may be the only investments class many students will ever take.

We intentionally wrote this book in a relaxed, informal style that engages the student and treats him or her as an active participant rather than a passive information absorber. We think the world of investments is exciting and fascinating, and we hope to share our considerable enthusiasm for investing with the student. We appeal to intuition and basic principles

whenever possible because we have found that this approach effectively promotes understanding. We also make extensive use of examples throughout, drawing on material from the world around us and using familiar companies wherever appropriate.

By design, the text is not encyclopedic. As the table of contents indicates, we have a total of 20 chapters. Chapter length is about 30 to 40 pages, so the text is aimed at a single-term course; most of the book can be covered in a typical quarter or semester.

Aiming the book at a one-semester course necessarily means some picking and choosing, with regard to both topics and depth of coverage. Throughout, we strike a balance by introducing and covering the essentials while leaving some of the details to follow-up courses in security analysis, portfolio management, and options and futures.

How Does the Seventh Edition of This Book Expand upon the Goals Described Above?

Based on user feedback, we have made numerous improvements and refinements in the seventh edition of *Fundamentals of Investments: Valuation and Management*. We updated an appendix containing useful formulas. We updated every chapter to reflect current market practices and conditions, and we significantly expanded and improved the end-of-chapter material. Also, our chapters devoted to market efficiency and to behavioral finance continue to rate highly among readers.

To give some examples of our additional new content:

- Chapter 1 contains updates on historical returns for small-company stocks, large-company stocks, long-term government bonds, Treasury bills, as well as U.S. inflation rates.
- Chapter 2 contains new material on AAI asset allocation models.
- Chapter 3 incorporates the new ticker symbols for exchange-traded options.
- Chapter 4 contains new material on the key difference between two popular S&P 500 ETFs.
- Chapter 5 contains new material on the Flash Crash of 2010 as well as updated material on circuit breakers.
- Chapter 6 contains a new section on enterprise value ratios. It also contains a detailed new example showing how to value Procter & Gamble Company using the models presented in the chapter.
- Chapter 8 contains new material on why investors find it difficult to sell losers. Students have an opportunity to take an online quiz about overconfidence.
- Chapter 11 contains new material on the fallacy of time diversification.
- Chapter 13 contains new material on the Sortino ratio.
- Chapter 15 contains new material on weekly options. The chapter also has updated material on credit default swaps (CDSs).
- Chapter 17 contains an updated valuation for Starbucks Corporation.
- Chapter 18 combines material on corporate, U.S. federal government, and municipal bonds previously contained in two separate chapters.
- Chapter 19 is a new chapter on global economic activity and industry analysis. This new chapter contains material relevant to investors striving to identify how best to allocate their portfolio weights.

In addition, we have updated learning objectives for each chapter. We have reworked our chapter summaries to reflect the chapter's learning objectives.

For the seventh edition, we significantly expanded and improved the end-of-chapter material. We added new problems throughout, and we have significantly increased the CFA™ content. We updated the questions that test understanding of concepts with no calculations involved. Additionally, our *What's on the Web?* questions give students assignments

to perform based on information they retrieve from various Web sites. Finally, in selected chapters, we have included spreadsheet assignments, which ask students to create certain types of spreadsheets to solve problems.

We continue to emphasize the use of the Web in investments analysis, and we integrate Web-based content in several ways. First, wherever appropriate, we provide a commented link in the margin. These links send readers to selected, particularly relevant Web sites. Second, our *Work the Web* feature, expanded and completely updated for this edition, appears in most chapters. These boxed readings use screen shots to show students how to access, use, and interpret various types of key financial and market data. Finally, as previously noted, new end-of-chapter problems rely on data retrieved from the Web.

We continue to provide *Spreadsheet Analysis* exhibits, which we have enhanced for this edition. These exhibits illustrate directly how to use spreadsheets to do certain types of important problems, including such computationally intensive tasks as calculating Macaulay duration, finding Black-Scholes option prices, and determining optimal portfolios based on Sharpe ratios. We also continue to provide, where relevant, readings from *The Wall Street Journal*, which have been thoroughly updated for this edition.

CFA™ Mapping

Consider this description provided by the CFA Institute: “First awarded in 1963, the Chartered Financial Analyst (CFA) charter has become known as the gold standard of professional credentials within the global investment community. Investors recognize the CFA designation as the definitive standard for measuring competence and integrity in the fields of portfolio management and investment analysis.” The importance and growing significance of the CFA charter are compelling reasons to integrate CFA curriculum material into our seventh edition.

Among the requirements to earn the CFA charter, candidates must pass three sequential levels of comprehensive exams. Each exam asks questions on a wide array of subject areas concerning the investment process. To help candidates study for the exams, the exams at each level are divided into so-called study sessions. Each of these study sessions has a core set of readings designed to help prepare the candidate for the exams. We carefully examined the content of each reading (updated for the 2012 exams), as well as the stated learning outcomes, to determine which areas we covered in the sixth edition. Importantly, we also considered which areas might be added to the seventh edition.

As a result of this thorough process, in our seventh edition we expanded coverage on seven readings and added completely new coverage of three readings. In total, our textbook contains material that touches over 75 percent of the readings from Level 1 of the CFA exam. Topics that we do not address from Level 1, such as basic statistics, accounting, and economics, are likely addressed in prerequisite courses taken before the investments course. In addition, we present some higher-level material: We touch on about 35 percent of the readings from the Level 2 and 3 exams.

Of course, we make no claim that our textbook is a substitute for the CFA exam readings. Nonetheless, we believe that our seventh edition provides a terrific framework and introduction for students looking to pursue a career in investments—particularly for those interested in eventually holding the CFA charter. To provide a sense of studying for the CFA, the seventh edition continues to include an end-of-chapter case review. *Schweser*, a leading purveyor of CFA exam preparation packages, graciously provided extensive material from which we chose these case reviews.

We provide a mapping between the textbook and the CFA curriculum as follows: Each chapter opens with a CFA Exam box citing references to specific readings from the CFA curriculum that are covered within the chapter. The topic is identified and we indicate which level and study session the reading comes from. We label these topics CFA1, CFA2, CFA3, and so on, for easy reference. End-of-chapter problems in the book and in *Connect* are also labeled with these tags. Over 95 percent of our end-of-chapter material is related to the CFA exam. We believe that this integration adds tremendous value to the seventh edition.

Assurance-of-Learning Ready

Many educational institutions today are focused on the notion of assurance of learning, an important element of some accreditation standards. This edition is designed specifically to support your assurance-of-learning initiatives with a simple, yet powerful, solution. Listed below are the learning objectives for each chapter.

Each test bank question for this book maps to a specific chapter learning objective listed in the text. You can use the test bank software to easily query for learning outcomes and objectives that directly relate to the learning objectives for your course. You can then use the reporting features of the software to aggregate student results in similar fashion, making the collection and presentation of assurance-of-learning data simple and easy.

Chapter Learning Objectives

Chapter 1: A Brief History of Risk and Return

To become a wise investor (maybe even one with too much money), you need to know:

1. How to calculate the return on an investment using different methods.
2. The historical returns on various important types of investments.
3. The historical risks on various important types of investments.
4. The relationship between risk and return.

Chapter 2: The Investment Process

Don't sell yourself short. Instead, learn about these key investment subjects:

1. The importance of an investment policy statement.
2. The various types of securities brokers and brokerage accounts.
3. How to calculate initial and maintenance margin.
4. The workings of short sales.

Chapter 3: Overview of Security Types

Price quotes for all types of investments are easy to find, but what do they mean? Learn the answers for:

1. Various types of interest-bearing assets.
2. Equity securities.
3. Futures contracts.
4. Option contracts.

Chapter 4: Mutual Funds and Other Investment Companies

You're probably going to be a mutual fund investor very soon, so you should definitely know the following:

1. The different types of mutual funds.
2. How mutual funds operate.
3. How to find information about how mutual funds have performed.
4. The workings of exchange-traded funds (ETFs) and hedge funds.

Chapter 5: The Stock Market

Take stock in yourself. Make sure you have a good understanding of:

1. The differences between private and public equity and between primary and secondary stock markets.
2. The workings of the New York Stock Exchange.
3. How NASDAQ operates.
4. How to calculate index returns.

Chapter 6: Common Stock Valuation

Separate yourself from the commoners by having a good understanding of these security valuation methods:

1. The basic dividend discount model.
2. The two-stage dividend growth model.
3. The residual income and free cash flow models.
4. Price ratio analysis.

Chapter 7: Stock Price Behavior and Market Efficiency

You should strive to have your investment knowledge fully reflect:

1. The foundations of market efficiency.
2. The implications of the forms of market efficiency.
3. Market efficiency and the performance of professional money managers.
4. What stock market anomalies, bubbles, and crashes mean for market efficiency.

Chapter 8: Behavioral Finance and the Psychology of Investing

Psych yourself up and get a good understanding of:

1. Prospect theory.
2. The implications of investor overconfidence and misperceptions of randomness.
3. Sentiment-based risk and limits to arbitrage.
4. The wide array of technical analysis methods used by investors.

Chapter 9: Interest Rates

It will be worth your time to increase your rate of interest in these topics:

1. Money market prices and rates.
2. Rates and yields on fixed-income securities.
3. Treasury STRIPS and the term structure of interest rates.
4. Nominal versus real interest rates.

Chapter 10: Bond Prices and Yields

Bonds can be an important part of portfolios. You will learn:

1. How to calculate bond prices and yields.
2. The importance of yield to maturity.
3. Interest rate risk and Malkiel's theorems.
4. How to measure the impact of interest rate changes on bond prices.

Chapter 11: Diversification and Risky Asset Allocation

To get the most out of this chapter, diversify your study time across:

1. How to calculate expected returns and variances for a security.
2. How to calculate expected returns and variances for a portfolio.
3. The importance of portfolio diversification.
4. The efficient frontier and the importance of asset allocation.

Chapter 12: Return, Risk, and the Security Market Line

Studying some topics will yield an expected reward. For example, make sure you know:

1. The difference between expected and unexpected returns.
2. The difference between systematic risk and unsystematic risk.
3. The security market line and the capital asset pricing model.
4. The importance of beta.

Chapter 13: Performance Evaluation and Risk Management

To get a high evaluation of your investments' performance, make sure you know:

1. How to calculate the best-known portfolio evaluation measures.
2. The strengths and weaknesses of these portfolio evaluation measures.
3. How to calculate a Sharpe-optimal portfolio.
4. How to calculate and interpret Value-at-Risk.

Chapter 14: Futures Contracts

You will derive many future benefits if you have a good understanding of:

1. The basics of futures markets and how to obtain price quotes for futures contracts.
2. The risks involved in futures market speculation.
3. How cash prices and futures prices are linked.
4. How futures contracts can be used to transfer price risk.

Chapter 15: Stock Options

Give yourself some in-the-money academic and professional options by understanding:

1. The basics of option contracts and how to obtain price quotes.
2. The difference between option payoffs and option profits.
3. The workings of some basic option trading strategies.
4. The logic behind the put-call parity condition.

Chapter 16: Option Valuation

Make sure the price is right by making sure that you have a good understanding of:

1. How to price options using the one-period and two-period binomial models.
2. How to price options using the Black-Scholes model.
3. How to hedge a stock portfolio using options.
4. The workings of employee stock options.

Chapter 17: Projecting Cash Flow and Earnings

Help yourself grow as a stock analyst by knowing:

1. How to obtain financial information about companies.
2. How to read basic financial statements.
3. How to use performance and price ratios.
4. How to use the percentage of sales method in financial forecasting.

Chapter 18: Corporate and Government Bonds

Conform to your fixed-income knowledge covenants by learning:

1. The basic types of corporate bonds.
2. How callable and convertible bonds function.
3. The different types of government bonds.
4. The basics of bond ratings.

Chapter 19: Global Economic Activity and Industry Analysis

If you want the supply of your investment services to be in high demand, you should:

1. Understand the process of top-down analysis.
2. Be able to measure the level of economic activity globally and domestically.
3. Understand the relation of monetary and fiscal policies to economic activity.
4. Be able to identify industry sensitivity to business cycles.

Chapter 20 (Web site only): Mortgage-Backed Securities

Before you mortgage your future, you should know:

1. The workings of a fixed-rate mortgage.
2. Government's role in the secondary market for home mortgages.
3. The impact of mortgage prepayments.
4. How collateralized mortgage obligations are created and divided.

How Is This Book Relevant to the Student?

Fundamental changes in the investments universe drive our attention to relevance. The first major change is that individuals are being asked to make investment decisions for their own portfolios more often than ever before. There is, thankfully, a growing recognition that traditional "savings account" approaches to investing are decidedly inferior. At the same time, the use of employer-sponsored "investment accounts" has expanded enormously. The second major change is that the investments universe has exploded with an ever-increasing number of investment vehicles available to individual investors. As a result, investors must choose from an array of products, many of which are very complex, and they must strive to choose wisely.

Beyond this, students are more interested in subjects that affect them directly (as are we all). By taking the point of view of the student as an investor, we are better able to illustrate and emphasize the relevance and importance of the material.

Our approach is evident in the table of contents. Our first chapter is motivational; we have found that this material effectively "hooks" students and even motivates a semester-long discourse on risk and return. Our second chapter answers the student's next natural question: "How do I get started investing and how do I buy and sell securities?" The third chapter surveys the different types of investments available. After only three chapters, very early in the term, students have learned something about the risks and rewards from investing, how to get started investing, and what investment choices are available.

We close the first part of the text with a detailed examination of mutual funds. Without a doubt, mutual funds have become the most popular investment vehicles for individual investors. There are now more mutual funds than there are stocks on the NYSE! Given the size and enormous growth in the mutual fund industry, this material is important for investors. Even so, investments texts typically cover mutual funds in a cursory way, often banishing the material to a back chapter under the obscure (and obsolete) heading of "investment companies." Our early placement lets students quickly explore a topic they have heard a lot about and are typically interested in learning more about.

How Does This Book Allow Students to Apply the Investments Knowledge They Learn?

After studying this text, students will have the basic knowledge needed to move forward and actually act on what they have learned. We have developed two features to encourage students in making decisions as an investment manager. Learning to make good investment decisions comes with experience, while experience (regrettably) comes from making bad investment decisions. As much as possible, we press our students to get those bad decisions out of their systems before they start managing real money!

Not surprisingly, most students don't know how to get started in buying and selling securities. We have learned that providing some structure, especially with a portfolio simulation, greatly enhances the experience. Therefore, we have a series of *Getting Down to Business* boxes. These boxes (at the end of each chapter) usually describe actual trades for students to explore. The intention is to show students how to gain real experience with the principles and instruments covered in the chapter. The second feature is a series of *Stock-Trak* exercises that take students through specific trading situations using *Stock-Trak Portfolio Simulations*, which can be found at the book's Web site, www.mhhe.com/jmd7e.

Because we feel that portfolio simulations are so valuable, we have taken steps to assist instructors who, like us, plan to integrate portfolio simulations into their courses. Beyond the