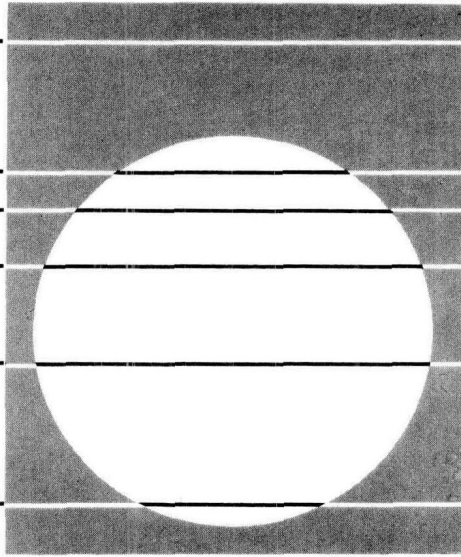


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Third Edition

SECURITY  
ANALYSIS  
AND  
PORTFOLIO  
MANAGEMENT

Donald E. Fischer / Ronald J. Jordan



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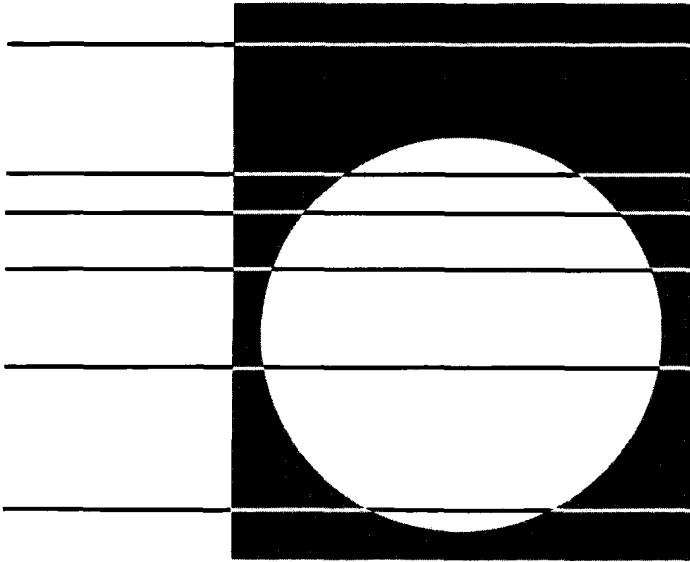
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To our parents,  
to Mary,  
to Sheryl,  
and Noah, Joshua,  
and Jeremy



# PREFACE

This book is about investing in securities. It is aimed at providing a comprehensive introduction to the areas of security analysis and portfolio management. The text approaches investing as a rational decision-making process in which the investor attempts to select a package or portfolio of securities that meets a predetermined set of goals. These investor goals are usually expressed in terms of return and the degree of uncertainty about the return or risk. More return is desirable; more uncertainty or risk is undesirable.

Special attention has been directed throughout to clarity of exposition. We have tried to make the contents as readable, understandable, and nonmathematical as possible. Only simple algebra and some elementary statistics are used in the book. For those who dread mathematics, even the algebra and the statistics are explained in lay terms.

In the past several decades the fields of security analysis and portfolio management have changed from a completely descriptive institutional body of literature to a highly formalized quantitative area of study. We have attempted to blend the best and most relevant pieces from the evolving field of endeavor into a meaningful, cohesive framework of analysis that would be of interest to the student of business and finance, the practitioner in the field, and the informed investor.

The text starts with the premise that the reader had no knowledge of investments but some knowledge of economics and accounting. As such, it should serve for an introductory course in investment analysis at either the undergraduate or graduate level. The material builds in difficulty as the chapters progress. The text is designed to be followed in the presented progression; however, some users will prefer to cover Chapters 16-22 early in the course. This can be done without loss in continuity. All chapters end

with comprehensive questions and/or problems that apply the material presented in the chapter.

An innovation of this work is the inclusion of a comprehensive continuing illustration of the application of the techniques of security analysis and portfolio management to a *real* stock and a *real* portfolio. Each chapter that presents tools of analysis includes an application of the tools to the Restaurant Industry and to McDonald's Corporation. This permits the reader to see the transference of explicated theory to a tangible real-life situation.

The book is divided into seven sections. Part I, The Investment Environment, contains three chapters. Chapter 1 surveys alternative investment vehicles, their more salient attributes, and the relative supply and demand for these investment types in the recent past. The functioning of major securities markets, or how an investor goes about buying and selling particular security types, is also examined (Chapter 2). Finally, the impact of differential taxes and transaction costs is explored, for these costs are a very real part of the investment decision (Chapter 3).

Part II, Framework of Risk-Return Analysis, sets forth in detail the theoretical tenants and practical dimensions of how security prices are determined and the manner in which returns are measured (Chapter 4). Equally important, we develop the notion of risk, what creates it, and techniques for stating risk in explicit quantitative terms (Chapter 5).

In Part III, *Common-Stock Analysis*, a detailed systematic approach to estimating future dividends and prices for common stocks is developed. The framework for the approach is an economic-industry-company analysis. The strong link between economic activity and security prices requires that the investor forecast the direction and degree of change in economic activity (Chapter 6). Key sectors of overall economic activity influence particular industries in different ways; the investor must link forecasts of economic activity to the prediction of relative movements in specific industries and analysis of selected industries (Chapter 7). From the industry level to the level of individual companies, the investor must examine and analyze factors that influence earnings, dividends, and stock prices of companies (Chapters 8-10).

Bonds and preferred stocks represent less exciting, but, nonetheless, important alternatives to common stock investing. The systematic sources of risk affecting bonds, particularly inflation, and changes in the level and structure of interest rates, are key areas in bond analysis that are examined first (Chapter 11). In addition, unsystematic risk and other nonrisk factors that influence required yields on bonds are explored in depth (Chapter 12). The final chapter in Part IV, *Bond Analysis*, probes specific passive and active strategies used to manage bond portfolios.

The chapters (14 and 15) in Part V, *Options*, examine various forms of security options that might be purchased or sold. These options represent rights to underlying common shares as well as fixed income securities.

The approach detailed in Parts III and IV is best described as *fundamental analysis*. Considerations of economic-industry-company analysis are linked in order to reach considered estimates of return and risk on individual securities. In Part VI we also develop the rationale and explore the methods employed by so-called *technical analysis* (Chapter 16). This approach concentrates on supply and demand relationships in the market and on historical price and volume relationships to predict the movement of the market as

well as the movement of prices of individual securities. The last segment of Part VI is devoted to the idea of efficient markets and the theory of random walk. The efficient markets notion questions the validity of technical analysis and also raises some questions about fundamental analysis (Chapter 17).

The risk-return output of security analysis is the raw material for portfolio management. Part VII, Portfolio Analysis, Selection, and Management, deals systematically with the procedures involved in portfolio management. Using modern methods for analyzing portfolios and packaging securities in such a way as to achieve diversification of risk is the first task to be accomplished (Chapter 18). The selection of the one best portfolio from those available to the investor is stage two of portfolio management (Chapter 19). Chapter 20 introduces capital market theory and extends the idea of diversification to include international securities. Following the analysis and selection of a portfolio, the investor must be attentive to revising it as economic conditions and the prospects for individual securities change (Chapter 21). The final chapter in the text (22) explores the ways in which an investor might place his funds in the hands of professionals for management, and how portfolios managed individually, or by others, might be evaluated for performance over time.

This edition of the text has some significant revisions which are worth noting:

1. A completely new industry and company are used as an integrating example to illustrate certain analytical aspects of security analysis. This edition examines the restaurant (fast foods) industry and a premier participant, McDonald's Corporation.
2. There are new chapters on options. These chapters examine puts and calls (including convertible securities) and the evolving interest-rate futures markets; they also discuss widely accepted trading strategies.
3. Rewritten chapters on transaction costs and taxes incorporate the latest developments in these areas.
4. An expanded chapter on accounting information exposes the reader to the very latest in areas of interest to analysts (e.g., replacement accounting, business segment reporting).
5. There is a new chapter on managing fixed income securities, including accepted passive and active strategies.
6. New material on the risks and rewards associated with international diversification is presented.
7. The revised and enlarged end-of-chapter questions and problems have had extensive class testing.
8. Additional aids to instructors in a greatly expanded teachers manual include specifics on setting up and administering a securities trading game, test banks, and suggested course outlines.

As in all large undertakings, the principals gain invaluable advice from numerous individuals. The authors are especially indebted to Richard McEnally, University of North Carolina, who has carefully reviewed every edition and provided valuable advice and encouragement. A number of practitioners have provided especially useful information and suggestions: David Marks, CIGNA Corporation; Pete Morley, Frank Russell Investment Company; Jim Vertin, Wells Fargo Investment Advisors; Jan Vanter, Stein, Roe and Fannham; Roy Burry, Kidder, Peabody and Company; Don Mazur, Dean, Witter,

Reynolds, Inc.; Ken Lynch, Travelers Corporation; Tom Hylinski, Peoples Savings Bank, and Mike Porreca, Aetna Life and Casualty. We are grateful to the Institute of Chartered Financial Analysts (ICFA) for permission to use certain questions and problems appearing on annual examinations for the designation Chartered Financial Analyst.

The manuscript was also vastly improved through the critical comments of our colleagues in academia: John Edmunds, Northeastern University; Adrian Edwards, Western Michigan University; Robert Hollinger, Kansas State University; Michael Robinson, Valparaiso University; Cathy Sherman, Michigan State University, and Tony Winger, University of North Carolina. Deborah Pauls, and Rhonda Perry typed various versions of the manuscript with their usual good cheer and efficiency. Finally, we are indebted to Dave Hildebrand and Esther Koehn for their special efforts in getting the manuscript into production and for following through to the bound book.

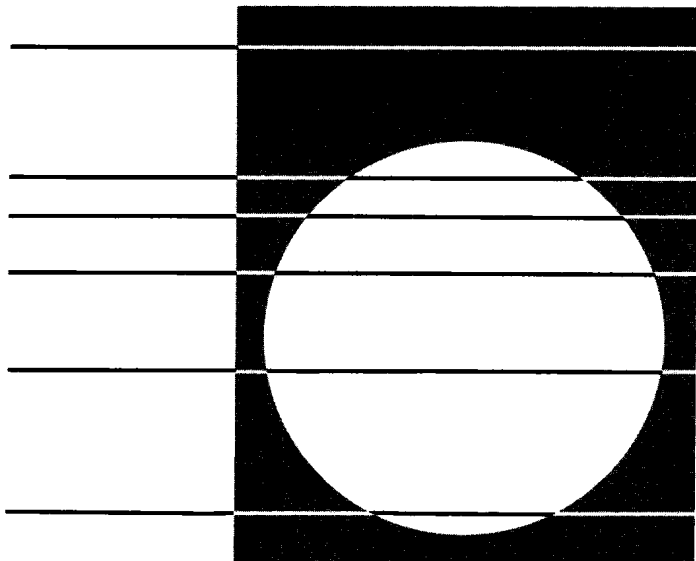
We invite all those who find this book useful to share with us any observations that might serve to improve the substance and employment of the contents.

DONALD E. FISCHER *and* RONALD J. JORDAN

*Stamford, Connecticut*  
*West Hartford, Connecticut*



SECURITY  
ANALYSIS  
AND  
PORTFOLIO  
MANAGEMENT



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